Small Business Management Research Reports

Income Tax Influences on Legal Form of Organization for Small Business

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INCOME TAX INFLUENCES
ON LEGAL FORM OF ORGANIZATION FOR
SMALL BUSINESS

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FOREWORD

This Small Business study, Income Tax Influences on Legal Form of Organization for Small Business, has been conducted and prepared under the direction of Dean Harold E. Wise, Project Director for The University of Nebraska.

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Only a limited number of copies of this report have been printed. It is available for reference in any of the Small Business Administration offices throughout the United States or at many reference libraries. Copies of the report also may be purchased for $2.00 directly from the College of Business Administration, The University of Nebraska, Lincoln 8, Nebraska.

Summaries of this study have been printed and are available in reasonable quantities. These summaries may be secured from SBA field offices or from the Small Business Administration, Washington 25, D. C.

The Small Business Administration assumes no responsibility for the accuracy of the data contained herein, nor does it necessarily endorse any opinions, conclusions or recommendations which may be a part of this report.

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CHAPTER I

INTRODUCTION

This study attempts to help the businessman realize the importance of considering Federal income taxes in relation to legal organization form before making business decisions by giving him illustrations of the effect of income taxes on actual businesses. The natural tendency of the businessman is to operate his firm in the best way he can throughout the year, then have his accountant or attorney prepare his tax returns at the end of the year. Tax-wise, this is not a very good procedure.

Many choices are available to the businessman which are designed to help him arrange his affairs so that he pays a fair tax without undue burden on the business. One of these choices is whether to pay tax as an individual, as a partnership, or as a corporation. Both Congress and the Treasury Department expect the businessman to understand the implications of the choices which are available and to pick the form which is best for his firm. As evidence of this assumption by the Treasury Department, the introductory remarks to their widely distributed pamphlet Tax Guide for Small Business[1/] contain the following advice:

> This booklet, designed primarily to help you prepare your 19-- income tax return, also contains information which will acquaint you, generally, with the tax consequences of decisions facing you throughout 19--. . . .
>
> You should become familiar with the Federal tax laws as they apply to your business so that you pay only your correct tax--no more and no less. You should, for example, understand the elections and choices which you have as to when and how certain kinds of income are taxed to you, and when and how certain expenditures shall be deducted. . . . You should understand the difference in the tax treatment of corporations, partnerships, and sole proprietorships.

1/ Treasury Department, Internal Revenue Service, Publication 334. Obtainable from the Superintendent of Documents, U. S. Government Printing Office, Washington 25, D. C. New editions are published each year.

Congress has recognized the importance of choosing the best legal form for each particular business and has attempted to make the choice easier by allowing certain small business corporations to elect to be taxed similarly to partnerships. When this provision was passed in 1958, the Senate Finance Committee report which accompanied the bill stated: "Your committee believes that the enactment of a provision of this type is desirable because it permits business to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences."[1/] As will be emphasized repeatedly in this study, the new election provided by the 1958 act did not really simplify the problem of the businessman in making a choice of legal form, but did give him a wider range of choices.

In many instances, however, the businessman does not fully understand the real impact of the choices which are available to him. There are many excellent publications which discuss the advantages and disadvantages of each of the forms of organization. Some, such as the government publication quoted above, deal with broad general principles and are simple and comparatively easy to understand. Others, such as those appearing in the professional literature of law, accounting, finance, and economics, are technical and probe deeply into fine points. However, few of them, easy or difficult, provide examples which demonstrate the exact tax status of specific businesses under alternative forms of organization, or under different methods which are available within each principal alternative. Yet, the businessman is used to thinking in terms of real business and actual situations. An extremely complicated principle becomes understandable and usable to him if explained in terms of what happened to the grocery store on the corner, or to his brother-in-law's plumbing business in their home town.

[1/] Reproduced, among other sources, at ¶ 4847.10 of CCH 1959 Standard Federal Tax Reports.

WHAT THIS STUDY DOES

General Summary

This study gives the businessman eight illustrations of the exact taxes paid by small businessmen who have recently had to choose a form of organization for their business. Each of these case studies tells the story of an actual business which is operating today.

These case studies are analyzed in a manner designed (1) to compare the amount of Federal income taxes which would have been paid under alternative forms of organization, and also (2) to use the experience of these firms to illustrate and demonstrate in as simple terms as possible the application of some of the more complicated tax factors which the businessman and his professional advisers should keep in mind when choosing the legal form for their business.

In order to limit the factual backgrounds to a similar basic situation, the case studies were restricted to firms which were started as sole proprietorships but were later changed to a partnership, corporation or other multiple interest form when the owner transferred an interest in the firm to another person but retained part of the firm.

The discussion is restricted to the broad general principles which the businessman must understand if he is to make the best decision for his own firm. This discussion is supplemented with extensive footnotes pointing out technical factors and referring to publications where these technical factors are analyzed in detail. These footnotes should, therefore, serve as a starting point for the businessman's attorney and accountant in researching the specific items which apply to the firm they are helping.

Limitations Placed on the Study

Tax Factor Only

The analysis is confined to Federal income taxes. Many other factors enter

into the choice of legal form of organization, and a proper choice can be made only after consideration of all factors, each properly weighed. Income tax is but one of those factors.

Since the analysis is confined to Federal income taxes, the word "taxes" is used to indicate Federal income taxes throughout the study. If other types of taxes are mentioned, they are specifically designated.

Cut-Off Date on Research

All of the computations and comparisons reflect the tax law which was in effect during 1960, or, in the instance of tax for prior years, the law which was in effect in those years. No effect is given to any changes in the law, court decisions, or rulings by the Internal Revenue Service which were released after 1960.

The Case Study Firms

Size of firm studied.--All of the case study firms are well within the range of businesses usually classified as small business.[1/] Most of them are what would be considered extremely small, but several larger firms are included. Several of the firms have annual sales of less than $100,000, but the largest firm had sales of over $2 million last year.

Types of businesses represented.--An attempt was made to select case study firms which are typical of the types of businesses customarily operated as small business. Care was taken not to use more than one or two firms in the same type

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[1/]There is no universally accepted criteria for classifying businesses as "small business," but all definitions include firms larger than those studied. For example, the Small Business Act of 1953, as amended, defines small business as "one which is independently owned and operated and which is not dominant in its field. . . ." In administering the act, the Small Business Administration has used a variable yardstick wherein it considers manufacturing firms small business if they employ less than 250 persons and large business if they employ more than 1,000 persons. The classification between these two tests depends upon individual circumstances. The criteria is changed from number of employees to sales in the case of wholesalers, retailers and service firms. Wholesalers are considered small business by the SBA if sales are under $5 million. Retailers and service firms are considered small business by them if sales are under $1 million.

of business. No problems are analyzed unless they are common to many firms in many lines of business.

Identity of the firms is disguised.--Since these case studies reveal the exact financial data of existing businesses, every attempt has been made to hide the identity of each. The exact nature of the firm's business is not mentioned. Not more than one or two firms were taken from any community. Similarly, no more than one or two firms are clients of any one accounting or legal firm.

Each firm is designated by a letter name only. Thus, the first firm analyzed is known as Firm A. Each of the owners is given a hypothetical name starting with the letter of his firm. The names chosen are common American names and have no reference to actual persons, living or dead. In no instance is the name of the actual owner of any of the case study firms used.

METHOD OF RESEARCH AND PRESENTATION

Source of Data

The case study firms were located through the cooperation of certified public accountants and attorneys. The cases were recommended by accounting firms and attorneys who had helped the firms choose their form of organization so knew that the firm had recently experienced a common organizational problem which is affected by Federal income taxes. After obtaining permission from the case study firm, data was compiled from the tax returns, financial statements and other data in the accountant's files, supplemented by conferences with the attorney and the businessmen themselves. In some instances, data was obtained directly from the records of the firm.

Basic Principles

Some of the most widely recognized principles of Federal income taxation as they relate to the choice of legal form of organization of small business are

summarized in Chapter II. The intent of the chapter is to review in simple language the basic principles which the businessman must have in mind as he studies the specific problems which are analyzed and illustrated in the case study chapters. Much of the material in Chapter II is based on articles which have appeared in professional journals and reviews recently.

Case Studies

A chapter is devoted to an analysis of each of the case study firms. Each contains the customary introductory paragraphs setting forth the areas to be analyzed and a summary and conclusions section which reviews the findings of the study. The principal portion of each chapter is divided into three analytical sections. The nature and content of each of these analytical sections is outlined in the next few paragraphs.

History of the Firm

The first section of each case study chapter reviews the general history of the firm. Extensive use is made of condensed, comparative financial statements to tell the story of the firm, but enough expository material is included to give a good understanding of the firm and the setting in which it operates. An attempt is made to guide the attention of the businessman who is not familiar with accounting toward the most significant data in financial statements.

Comparison of Tax Under Alternative Forms of Organization

The second section of each of the case study chapters contains an empirical comparison of the Federal income taxes which would have been paid by the firm under alternative forms of organization. The tax which was actually paid was compiled from the accountant's files and from the records of the company at the same time the general historical material was gathered. The tax which would have been paid

under other forms of organization had to be computed by us. These computations filled many sheets of wide columnar paper. In order to concentrate on results, these work sheets are being kept on file at the University of Nebraska and only a summary is included in this report. This summary compares the tax which would have been paid under each of the following alternatives for each firm: (1) partnership or proprietorship, whichever applies to the firm, (2) tax-option corporation, (3) conventional corporation with optimum tax planning, and (4) conventional corporation with no tax planning.

The computations in the second alternative, "tax-option corporation" refer to the partnership-like election under the provisions of Subchapter S of the Internal Revenue Code. The firms which have chosen this election are sometimes known as "Subchapter S corporations" and "pseudo corporations" as well as "tax-option corporations."

The term "optimum tax planning," which is used in the third alternative, is a term coined during the research for this paper to mean arranging the affairs of the corporation in such a way as to reduce the tax to the lowest possible amount over a period of years <u>without violating the law or the spirit of the law</u>. In other words, it is effective, practical tax planning. It is assumed that Congress intends for small corporations to pay reasonable salaries to those owners who work in the firm and to pay interest on legitimate loans the owners may have made to the corporation. These salary and interest payments are examples of optimum tax planning as that term is used in the case study chapters.

The computations under the fourth alternative, "conventional corporation with no tax planning," assume that salaries and withdrawals are the same as they were, or would have been, in the partnership form. Thus, it refers to the way things would probably be done if careful thought were not given to tax.[1/]

1/ The terms described in this paragraph are explained further and are illustrated in the write-up of the first case study. See pages 34-35 in Chapter III.

Some Warnings to the Reader

Comparisons must cover several years.--Meaningful comparisons of tax under the alternative forms of organization discussed in the preceding section must cover more than one or two years. The interplay of computational factors causes a constant shifting of short-term tax results. Almost all of the case studies in this report show that the lowest tax results from the partnership form in some years, from the tax-option corporate form in some years, and from the corporate form with optimum tax planning form in a few years.[1/] The only valid comparison is the total tax over several years.

Specific computation for each firm mandatory.--The businessman should guard against concluding that, since the case studies in this report reflect similar tax burdens over a period of years in three of the organizational forms, he can indiscriminately operate in any of those forms. Each firm has its own peculiar combination of facts. Some firms find that there is little difference in tax between the three, but others find distinct tax disadvantages in one or more forms.

The disturbing factor is that there is no way to predict the category into which a particular firm will fall. The only way to find out is to sit down and compute the tax under each alternative under each of the likely assumptions. This is hard work, but is not as bad as it sounds. And, it pays handsome rewards for those with the perseverance to carry it through.

The tabulations in this report show explicitly the type of computations which need to be made and the data which must be at hand in order to make them. The mathematical details are omitted so that the reader can concentrate on the effects of different alternatives. Many excellent manuals and sets of instructions are available showing how to make the computations once one knows what it is he needs to compute. Such detail has no place in this report.

1/ Even the conventional corporate form with no tax planning will result in the lowest tax once in a while. For example, Firm B would have paid less tax in that form in 1956; yet, the total tax over a period of seven years would have been considerably higher than in any one of the other three forms. (See Table 6, Page 49).

Special Problems

Each of the firms which have been selected for the case studies has encountered one or more complicated features or problems which have wide applicability to other small businesses which will be forming a partnership, corporation, or other multiple-interest organization. The third section of each of the case study chapters is devoted to an analysis of some of these problems. Different special problems are analyzed in each chapter.

No attempt is made to discuss every problem faced by each firm. Instead, from one to three principles or problems which can be effectively demonstrated or illustrated by the experience of the firm are selected. The research was centered around the Internal Revenue Code and Regulations, and was guided by the explanations in the tax reporting services and articles in professional journals and magazines. Key court cases were read and traced through a citator table to be sure they are still being followed. Special emphasis was placed on the reading of current cases in order to try to discern trends. However, no attempt was made to read every court case bearing on an issue so as to make a complete legal analysis of any problem. The emphasis is, as was noted earlier, on demonstrating the effect of a few generally recognized principles in a way which will let the businessman see what they mean in terms of their effect in an actual situation. Sufficient footnotes are included to help the general practitioner who is advising the businessman with a similar problem start his research, but no attempt is made to answer specific legal questions in this report. 1/

Some of the special areas which are discussed in the case study chapters include: (1) How the proprietor's wife can be effectively brought into the organization when a corporation is formed; (2) Advantages which can be obtained by having the former proprietor retain buildings or property and rent them to the corporation; (3) How to make a non-taxable transfer of a business to a corporation;

1/ general conclusions are, of course, only the personal opinions of the authors, and might not be upheld as legal interpretations become available in the future.

(4) How tax can make it almost impossible to sell an interest in a business to a close relative; (5) Qualification for the Subchapter S partnership-like tax option; (6) Sale vs. non-taxable contribution of assets to a partnership; (7) Sale vs. non-taxable contribution of assets to a corporation; (8) Debt owed to stockholders; (9) Use of two or more corporations; (10) The net operating loss deduction; (11) Basis of a partnership interest as a limit on the deductibility of losses; (12) Losses on small business corporation stock; (13) Basis problems of corporations which choose the Subchapter S tax-option; (14) Projection of future taxes as an aid in choosing form of organization; (15) Effect of Subchapter S tax-option on Social Security; and (16) Effect of gifts of stock to children.

If a firm has encountered a problem which has been analyzed in another chapter, the net effect is noted and cross-referenced to the discussion in the other chapter. In some instances, a simple example and discussion are included in one chapter and are followed with a more complex example and analysis in another chapter.

The proprietor who is transferring a portion of his business to another person and so has to choose one of the multiple interest forms of organization will encounter many tax problems which are not discussed in this report. The case studies which are included in this report were selected, from those which were developed as part of the research project, because they provide clear illustrations of some of the more complex problems which are commonly encountered.

Concluding Chapter

The final chapter has two primary functions. First, it summarizes the empirical data on the comparison of taxes which the case study firms would have paid in the past under alternative legal forms of organization. Second, it reviews the principles illustrated in the special problems section of the case study chapters. These principles may not have any connection individually, but when reviewed as a group present a summary of some of the most important factors the organizer of a small business should keep in mind.

CHAPTER II

SOME BASIC PRINCIPLES

The choice of forms of organization which are available to the proprietor who transfers part of his business to another person is usually the choice between partnership, tax-option corporation, and conventional corporation. Some of the most important differences in taxation under each of these forms are reviewed briefly in this chapter so that they may be used as background and as a point of reference.

No attempt is made to analyze these principles in detail, but frequent reference is made to other writings where the ramifications of each may be explored or to sections of the statute and regulations which can serve as a starting point for further study. The citations cover only a few of many fine articles and treatises and reflect only a portion of those which were used in the research for this paper. Generally, citations are to sources which are available in college and state libraries. Priority was given to sources which are most apt to be found in the libraries of practicing accountants and attorneys.[1/]

An abbreviated form of footnote is used. The names and addresses of publishers and similar information can be obtained from the "Works Cited" section at the end of the report.

[1/] Detailed data is available in any of the tax services and encyclopedias. Good basic summaries can be found in the proceedings of the various tax institutes, such as those sponsored by New York University, University of Southern California, Tulane University, and many shorter sessions, and in symposium issues of law reviews. Four recent symposium issues devoted to form of organization are: December, 1959, Vanderbilt Law Review; May, 1960, Kansas Law Review; Winter, 1960, Tennessee Law Review; and July, 1960, Wisconsin Law Review (directed specifically at farms and farmers). Every tax, accounting, and legal journal has occasional articles on form of organization. The continuing education committees of professional associations have published excellent pamphlets and books on the subject.

WHO IS TAXPAYER

One of the primary distinctions between the forms of legal organization is centered around the question of "who is the taxpayer?" For many years, the question was easy to answer. When the corporate form was used, the firm itself was the taxpayer. When the partnership or other form was used, the firm itself did not pay tax, but each owner included his share of the firm's earnings in his personal return and paid the tax personally. Thus, all firms were, in effect, taxed as either corporations or as individuals.[1/]

In 1958 Congress amended the Internal Revenue Code by adding Subchapter S which allows the stockholders of certain small corporations to elect to pay tax on their share of their corporation's earnings, thereby excusing the corporation from paying any tax as a firm.[2/] The procedure is similar to that used by partnerships. However, as will be emphasized throughout this report, there are many features of the new choice which can cause serious hardship which is not encountered by partnerships, and some provisions which give advantages not available to partnerships.[3/]

Some differences between corporate and individual taxes are summarized under two major classifications: (1) taxation of ordinary income, and (2) taxation

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[1/]Hybrid forms of organization report and are taxed as corporations or as partnerships (i.e., individuals) according to the form they resemble most. The only exception is the taxation of trusts and estates. These organizations report on a special fiduciary tax return. They are taxed essentially as individuals, but special rules apply to distributions and other special features.

[2/]The reasons for enactment of this section were summarized on page 2 in Chapter I. The designations given to firms choosing the election are discussed on page 7 of Chapter I.

[3/]In 1954 Congress enacted a converse provision which permits certain partnerships to elect to be taxed as corporations. (Code Sec. 1361). Certain rather strict provisions must be met. So few firms have availed themselves of this election that it is not discussed in this study. It has no general application to firms of the size studied.

of capital gains and losses.[1/]

Taxation of Ordinary Income

Taxable Income

The computation of taxable business income is essentially the same under all forms of organization. All items of income must be included in the return and all ordinary and necessary business expenses may be deducted. A conventional corporation pays tax on the net income so computed. Partnerships and tax-option corporations submit an information return showing each owner's share of this net income, but the firm itself pays no tax.

In the partnership form, each owner then picks up his share of each type of income reported by the partnership on his individual return along with the other income he may have. In the tax-option corporate form, everything is treated just as it is in a conventional corporation except for net operating losses, capital gains (but not losses), and net income. The first two items are passed through to the stockholders in a manner similar to that for partnerships.[2/] Net income is allocated to dividends in a complicated three-tier system,[3/] but the

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[1/] An insight into the basic tax system is sometimes easily obtained by examining proposals for change. The House Ways and Means Committee held a number of hearings on this topic in the fall of 1959. For a concise summary of proposals made to that committee, see Harrington, "Reforming the Federal Tax System," 109 Journal of Accountancy (June, 1960) p. 30.

[2/] Note that net operating losses are allocated to shareholders according to the number of days they owned the stock, while the net income is taxed to the person who owned the stock on the last day of the year. Capital gains are allocated according to the proportion of such gains in the corporation to total profits, but are limited by the shareholder's share of corporate income.

[3/] This tier system is used to determine if dividends are from previously taxed income (so are non-taxable to stockholder when received). The three tiers are basically:

a. Dividends are first allocated to money dividends paid during the year.
b. Any excess from "a" is allocated ratably to the constructive distribution of undistributed taxable income and actual distributions in property not in exchange for stock (note that only cash dividends are included in "a").
c. The remainder is available to be allocated to distributions in exchange for stock such as distributions under Code section 302 or 331.

net effect in most instances is that the stockholder pays tax on the actual dividends he receives and treats any remainder of his share of net income over his actual dividends as a constructive dividend. The dividends exclusion and credit do not apply to dividends from tax-option corporations. The net effect in most tax-option corporations is the same as if the firm had reported as a partnership, but individual circumstances can result in significant differences.[1/]

Individuals are allowed to subtract two additional groups of items before arriving at their taxable income. First, they are allowed certain personal deductions.[2/] Second, they are allowed to deduct $600 for each exemption to which they are entitled.

Tax Rates

Corporate rates are 30% on the first $25,000 of taxable income and 52% on all taxable income above $25,000.

Individual rates are progressive, starting at 20%[3/] and moving to a maximum

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[1/] For a comprehensive analysis of Subchapter S provisions, see Chapin, "Subchapter S vs. Partnership: A Proposed Legislative Program," 46 Virginia Law Review (Jan., 1960) p. 61; or Willis, "Incorporate and Elect Subchapter S? Pros and Cons for Proprietors, Partners," 11 Journal of Taxation (Aug., 1959) p. 66.

[2/] Only items specifically deductible may be used as personal deductions. These include charitable contributions, interest, taxes, unusual medical expenses, certain child care expenses, casualty losses, and numerous sundry items specified in the Code. This is to be contrasted with business expenses which are deductible so long as they meet the general qualifications of "ordinary and necessary." (Code Sec. 162(a)).

[3/] In effect the beginning rate is zero on the amount covered by exemptions. For example, the tax rates and amount of tax which would be paid by a married man with two children and a taxable income of $15,000 after business and personal deductions is:

Rate	Income	Tax
0% on the amount of the exemptions (4 of $600)	$ 2,400	$ -0-
20% on the next $4,000	4,000	800
22% on the next $4,000	4,000	880
26% on the next $4,000	4,000	1,040
30% on the remainder	600	180
Totals	$15,000	$2,900

of 91%. The total tax, however, cannot exceed 87 per cent of taxable income.

Double Taxation

Under the conventional corporate form the firm pays tax on its earnings, and the owners pay tax again when the earnings are distributed as dividends. Thus, there is obviously double taxation.

This double taxation is often not as serious in small corporations as would appear at first impression, however. To the extent that earnings can be withdrawn in the form of salary, the tax result will be nearly the same as in the partnership form.[1] In addition, many businessmen loan money to their corporation instead of making all of their investment as capital stock. The interest on this debt is a deductible expense by the corporation.[2] Thirdly, part of all of the remaining earnings are often left in the business instead of being withdrawn as dividends.[3] Finally, the difference in tax rates sometimes makes the corporate form desirable in spite of double taxation.

Taxation of Capital Gains

Rates

The maximum rate of taxation of capital gains is 25 per cent. This maximum applies to all taxpayers, both corporate and individual.

Long-term Capital Gains Deduction

Only half of net long-term capital gains[4] are taxable to individuals.

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[1]As is emphasized repeatedly throughout this report, salaries must be reasonable or part will be disallowed and treated as a dividend.

[2]As is also repeatedly emphasized throughout this report, loans from stockholders must be real loans and not stock in disguise, or the "interest" will be disallowed and treated as a dividend.

[3]There must be a sound business reason for retaining the earnings in the firm or a penalty may be assessed under Code Section 531. This penalty tax is discretionary on the part of the commissioner except that he cannot assess it if retained earnings are under $100,000. Rates are 27½% on the first $100,000 of unreasonably assessed earnings and 38½% on the remainder.

[4]Specifically, the excess of net long-term capital gains over net short-term capital losses. (Code Sec. 1202).

Corporations pay tax on the entire amount of long-term capital gains. Individuals who are in the lower brackets thus have a distinct advantage over corporations.[1]

Real and Depreciable Property

One of the widely misunderstood principles of taxation of capital gains and losses concerns the taxation of the sale of real and depreciable property which has been used in a trade or business. Neither of these groups of assets are ever capital assets for tax purposes. However, the sale of these assets is treated as a long-term capital gain in one, and only one, special circumstance. That special circumstance occurs when the net result for an entire year of all sales of real and depreciable property which has been used in the trade or business of the taxpayer and has been held for more than six months[2] results in a gain. If the net result of such sales is a loss, each sale is reported as an ordinary sale. Similarly, the sale of these assets is always reported as an ordinary sale if they have not been held for six months. Real and depreciable property used in a trade or business is never, under any circumstances, reported as a short-term capital gain or loss.[3] [4]

The result of this special treatment is that the taxpayer gets a break. When

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[1]For an expanded discussion, see Ray and Hammonds, "Partnership or Corporation: Tax Considerations," 36 Taxes (Jan., 1958) p. 10.

Since, as was pointed out on page 11, an abbreviated style of footnote is being used, complete data must be obtained from the "Works Cited" section at the end of this report.

[2]Twelve months in the case of draft, breeding or dairy livestock.

[3]This special provision is contained in Sec. 1231 of the Code.

[4]For a comprehensive but understandable treatment, see Harnett, Capital Gains and Losses.

there are net gains, capital gains rates are applicable. When there are net losses, these losses are deductible in full.

FACTORS WHICH AFFECT THE PROPER CHOICE OF FORM OF LEGAL ORGANIZATION

There is no one best form of legal organization. There are advantages and disadvantages to each form. The next few pages summarize a few of the most important factors. The discussion is indicative of the type of factor which must be considered by the proprietor who is choosing a new form of organization as he brings another person into his firm, but no attempt is made to include every factor. Many of the factors mentioned are illustrated and analyzed in detail in the case study chapters.

Factors Present When the Choice Is Made

Income from Other Sources

The income which the owners of a business derive from other sources is of primary importance in choosing the form of legal organization. Generally, the corporate form becomes more attractive as the owner's other income increases. Even though there is double taxation,[1/] there is an advantage in having some of the income taxed at the corporate rates when the individual rates of the owners reach a certain level.

Family Situation

Exemptions.--An individual is not taxed[2/] on income of $600 per year for each exemption he claims. Thus, a married man with six children could claim eight

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[1/] See Garcia, "When Should a Sole Proprietor Incorporate His Business to Save Income Taxes," 35 Taxes (March, 1957) pp. 110-114 for an analysis of this double taxation in terms of the taxation when income is earned, and again when the remaining income is distributed.

[2/] See footnote 3 on page 14.

exemptions of $600 each or $4,800. Add to that his personal deductions[1/] and it is obvious that he can have a sizable income from a business before he owes any tax. In this situation, the use of a tax-option corporation, partnership, or other form wherein the owners, rather than the firm itself, are taxed, is indicated.

Family partnerships.--The family situation may point to the use of family partnerships. Instead of operating as a sole proprietor or as a one stockholder corporation, a lower tax bracket can often be achieved by forming partnerships with children or relatives, or with trusts for minor children.

A person may be a partner if he owns a capital interest in a partnership in which capital is a material income-producing factor even though that interest is acquired by gift. So, a father can give his child a gift of a partnership interest in his business and thereafter the income is split between them, thus attaining a lower bracket. The gift must be bona fide, however. In addition, there must be a provision for reasonable compensation for the services rendered to the partnership by the father (or other donor).

Estate Planning.--The corporate form offers important advantages in estate planning because shares of stock can be transferred to different persons, trusts, or other holders, while partnership interests cannot be. While this is primarily a business advantage rather than a purely tax advantage, there are many tax implications. These advantages are available to tax-option as well as conventional corporations.

Loss of capital gains advantage.--When 80 per cent of the stock of a corporation is owned by one individual, his spouse, minor children and grandchildren, gains on the transfer of depreciable assets to the corporation will be taxed as

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[1/] Either 10 per cent of his adjusted gross income (generally, but not exactly, his business income) or the actual expenditures for the items indicated in footnote 2 on page 14. The standard (10%) deduction is limited to $1,000. (See page 105, Federal Tax Course, 1961 by Commerce Clearing House, or comparable sections in other courses for a concise summary).

ordinary income instead of at capital gains rates.[1/] A similar, but slightly different, provision applies to partnerships.[2/] When this condition exists, the suggestions made on page 21 and in the case study chapters relating to getting a stepped-up basis by selling assets to the new firm are inapplicable.

Similarly, losses are not recognized at all between certain related persons, including a businessman and a corporation or partnership in which he owns more than a 50 per cent interest.[3/]

Alternatives Within the Broad Choices

There are many alternatives within the framework of choice between partnership, tax-option corporation and conventional corporation which should be considered. A few of the most common are mentioned in the next few paragraphs.

Several corporations.--Instead of forming one corporation, several corporations can sometimes be formed, thus keeping more of the income in the lower 30 per cent bracket which applies to the first $25,000 of corporate income.[4/] There may also be less likelihood of several small salaries being challenged as unreasonable than one large one.

There must be a sound business reason for using small corporations or the Commissioner may tax all as one corporation.[5/]

1/Code sec. 1239.

2/Code sec. 707.

3/Explored further in Chapter IV.

4/An example of when not to form two corporations is included in Chapter VI.

5/Code sec. 1551; also, Coastal Oil Storage Company v. Commissioner, 57-1 USTC 9518 (CA-4).

Incorporate only part of a business.--There are often distinct advantages in incorporating part of a business and retaining part in the partnership or proprietorship form. For example, real estate could be so retained and be rented to the corporation.[1]

Limited partnerships.--By meeting strict statutory requirements, which are designed to warn creditors that they can claim only the assets of the firm and of the general partners, one or more partners can limit his liability to the amount invested in the firm. By using this type of partnership, inactive owners can often gain the limited liability which they would obtain in the corporate form while retaining the tax advantage of the partnership. However, from a business standpoint, management and control must be left in the hands of the general partner (or partners). The owners may not wish to do this. From the tax viewpoint, moreover, there is a danger that the Commissioner may attempt to treat the organization as an association taxable as a corporation.[2]

Should incorporation be tax-free?--This question is discussed in several places in the case study chapters, but is so often overlooked that it is also pointed out in this chapter on basic principles. When a new form of organization is adopted, the transfer of assets to the new firm can often be either tax-free or taxable at the option of the owners. If the transaction is arranged so as to be taxable, the former owners will pay tax on any gain, probably at capital gain rates under the provisions of Section 1231 of the Code, but higher basis for gain or loss and for depreciation will be obtained for the assets in the hands of the corporation. If the transaction is arranged so as to be tax-free, the corporation will assume the adjusted basis of the assets to the former owners.

1/ Illustrated in Chapter III.

2/ I.T. 3920. For an expanded, non-technical discussion, see Driscoll, "The Limited Partnership and the Association Question," 1960 So. Calif. Tax. Inst., p. 539.

Where conservation of immediate working capital is not an absolute must, a taxable exchange offers ample long-term reward in future tax savings. Yet it often seems to be overlooked.

Sundry Factors Present When the Choice Is Made

New opportunity for elections.--When a second owner is brought into a firm, there is usually a new opportunity to make elections. Often, elections are inadvertently made without sound thought by simply doing, or not doing, something in the first tax return of the firm. Among such elections are (1) choice of fiscal year, (2) choice of method of accounting, especially regarding installment sales and completed contracts, not to mention the basic one of cash or accrual basis, (3) choice of method of handling bad debts, and (4) depreciation methods. All such elections should be carefully planned before the choice of form of organization is made.

Loss of some tax advantages.--Careful thought should be given to the manner of handling such things as capital loss carryovers, net operating loss carryovers, state unemployment merit ratings, etc. In some instances some of these can be carried over to a new organization, but it is important to get sound legal advice ahead of time. The precise method of handling the formation of the organization may determine whether or not these, and similar items, can be carried over to the new firm.

Organization expenses.--A corporation can amortize organization expenses over a period of not less than 60 months.[1/] A partnership cannot deduct organization expenses, but must treat them as a capital expenditure for tax purposes.

Factors in the Operation of the Business

The proprietor who contemplates transferring part of his business to another

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[1/] Code section 248.

person must consider the future as well as the present circumstances in choosing the form of legal organization for the firm. The nature of the business and the possible direction which future operations will take are important considerations. The next few paragraphs summarize a few of the factors in the future operation of the business which must be considered. These items are indicative of the type of factors which should be considered and are not intended to be all-inclusive.

Types of Income and Deductions

The type of income which the business will have often dictates the type of organization which must be chosen. This is true primarily because all income loses its identity and nature when it gets to a corporation. For example, interest on municipal bonds is exempt from Federal income taxes. But, if these bonds are owned by a corporation, dividends paid by the corporation from interest received on exempt bonds are still taxable to the stockholder. This is true of both a conventional and a tax-option corporation. On the other hand, if a partnership collects exempt interest, it retains its exempt character in the tax return of the individual partners.

On the other hand, there are some kinds of income in which the corporation provides advantages. For example, 85 per cent of dividends received from most domestic corporations which pay income taxes are exempt to a corporate taxpayer[1/] whereas individuals (including partners) have an exemption of only $50 plus a credit of 4 per cent.[2/]

Income loses its identity in the tax-option corporation just as in the

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[1/] Code sec. 245; regulations sec. 1.245-1.

[2/] Note that this is a credit of 4%. Four per cent of the dividend is subtracted from the tax, not the taxable income, so is the equivalent of a 20% deduction for a taxpayer in the 20% (lowest) bracket.

conventional corporation except for capital gains and losses and net operating losses.

Personal Holding Company Pitfall

When a corporation is owned by five or less families, a severe penalty tax can be assessed if the firm's income is from certain sources. These sources include such things as dividends, interest, profits on trading of securities, and sometimes rent. When a corporation is within both the ownership and the type of income provisions, the personal holding penalty tax is assessed against all income which is not distributed. This tax starts at 75 per cent on the first $2,000 of undistributed personal holding company income and goes to 85% on the remainder.[1/]

The corporation form should not, therefore, be used when the firm will be closely held and income is from the sources mentioned above unless the firm will be able to distribute all income currently. The Subchapter S tax-option election is not available to firms with 20% or more "personal holding company income."[2/]

Fringe Benefits

Stockholders of both a conventional and a tax-option corporation may also be employees of the firm. As employees, they qualify for the same fringe benefits as may be made available to other employees. These may include stock options, deferred compensation plans, pension and profit sharing plans, and health insurance plans.

When these plans can be put into effect, a significant tax advantage may be obtained. The employee-stockholder is taxed when he collects a pension, for example, rather than when the funds are set aside for him, yet the firm gets to

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[1/]For an expanded discussion, see Ray and Hammonds, "Partnership or Corporation: Tax Considerations," 36 Taxes (January, 1958) page 3.

[2/]Reg. Sec. 1.1372-4(5).

deduct the cost as the funds are set aside. The employee-stockholder will likely owe little or no tax on the pension after retirement because he will be in a lower tax bracket. In addition, distributions are usually subject to the retirement income credit, and up to $100 a week may be exempt as sick pay under certain circumstances. If paid at death, up to $5,000 may be covered by the death benefit exclusion. And, if the fund is paid in a lump sum, the gain is sometimes taxable at capital gains rates.[1/] The cost of some fringe benefits, such as certain health programs, are deductible to the corporation but do not have to be included in the employee's income.

These advantages are not available to a partner.[2/]

Leveling of Income

When income fluctuates considerably from year to year, the conventional corporate form may allow some leveling. This is accomplished by distributing earnings of high income years in other years through dividends, bonus plans, etc. Profits in an exceptionally good year can be distributed as dividends over several years. Where the corporation is on the accrual basis and officer-stockholders on the cash basis, bonuses can be accrued in the high year but paid in the following year.[3/] Since partners and stockholders in tax-option corporations must pay on their share of partnership income when the firm earns it, it is harder to level the income as between years when these forms are used.

Carryover of Expense Deductions

When a proprietorship is being changed to another form of legal organization,

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[1/] For a concise but comprehensive summary, see Grayck "Taxation of Distributions from Qualified Pension or Profit Sharing Plans" 39 Taxes (Jan. 1961) p. 34.

[2/] A bill allowing partners and proprietors to deduct some contributions to retirement plans passed the House in 1960 but Congress adjourned before the Senate took action.

[3/] Prentice-Hall Tax Ideas ¶ 7034.3.

consideration must be given to the possibility that expense deductions might be lost. This could happen, for example, in the incorporation of a cash basis proprietorship. If the liabilities of the proprietorship are not paid by that business before the incorporation is complete, the expense deduction is lost. The payment of the liabilities by the corporation is simply payment of a liability, so must be capitalized. Thus, no deduction would be allowable to either organization.[1/]

Use of Fiscal Year Different from Taxable Year of Owner

Partnerships must choose a fiscal year which coincides with the fiscal year of the major partners unless specific permission for a different year is granted by the Commissioner. Corporations and tax-option corporations can choose any fiscal year they choose. In the case of the tax-option corporation, this can defer the payment of tax for up to eleven months.[2/]

Factors Involving Liquidation and Termination

The tax effect of liquidation or other termination of the business is a factor which should be considered seriously at the time the form of legal organization is chosen. A few of the major considerations are pointed out in the next paragraphs.

Collapsible Corporations and Partnerships[3/]

Businesses which organize with the intent of completing some special project

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[1/] For a more complete discussion, see Willard, "How to Organize a New Business to Obtain Maximum Tax Savings," 9 Journal of Taxation (August, 1958) p. 74.

[2/] Illustrated in Chapter IX

[3/] For a comprehensive analysis of collapsible corporation provisions, see Greene (editor) "Collapsible Corporations: A Symposium on What Is and What Is Not Collapsible," 12 Journal of Taxation (April, 1961) p. 194. For an integration of corporate and partnership provisions see Axelrad "Collapsible Corporations and Collapsible Partnerships" 1960 So. Calif. Tax Inst., p. 269. Section 337 is discussed further in Chapter VI.

or venture, then dissolving, should be wary of the collapsible provisions. Under these provisions, the gain to the owner on dissolution can, under certain conditions, be taxed as ordinary income rather than as capital gain.

While the collapsible provisions were originally enacted to close a loophole wherein ordinary profits were received at capital gains rates, it is possible to catch innocent businessmen unless they are wary of the provisions.

Sale of Corporate Business

It makes little difference if a corporation sells its assets and then distributes the proceeds or if it distributes the assets to the stockholders and lets them sell the assets, provided certain technical provisions of Code section 337 are met. This section requires that the corporation adopt a plan of liquidation and notify the Commissioner of the plan promptly, then distribute all of the assets within 12 months.[1/] If the technicalities are not met, two taxes may have to be paid--one by the corporation on sale of the assets and another by the stockholders when the proceeds are distributed. Partnerships are not bothered by this possible double tax. Since tax-option corporations are corporations for every purpose except payment of tax, the liquidation rules are presumedly the same as for conventional corporations.[2/]

Sale of a Partnership Interest

The sale of stock in a corporation results in a capital gain to the stockholder. By contrast, the portion of the proceeds from sale of a partnership interest which is payment for unrealized receivables and substantially appreciated

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1/A limited amount of assets to pay claims, etc., may be held longer than 12 months under some circumstances.

2/The proposed regulations denied the election to a corporation which was in the process of liquidation but was deleted in the final regulations. However, the firm may still run afoul of the 20% personal holding company type income provision.

inventory items is taxed at ordinary rates. These provisions are especially important to firms which ordinarily report on the cash basis, such as doctors and farmers. If the partnership form is chosen, care should be taken to insure that each of the partners understands the implications of these provisions.

SUMMARY AND CONCLUSIONS

When a proprietor transfers a portion of his interest to another person, he must choose a new form of legal organization. That choice is usually between (1) partnership, (2) conventional corporation, or (3) tax-option corporation. The taxes which are paid are vastly different under each of these forms so a proper choice is one of the most important decisions the businessman will ever be called on to make during his business life.

Businesses are taxed as individuals or as corporations. Partnerships, including joint ventures and other organization which use the partnership form, and tax-option corporations file information returns only and each owner pays tax on his share of the firm's profit, whether or not he withdraws that profit from the firm. These forms are, therefore, really taxed as individuals.

The proper choice of form of legal organization affects a firm and its owners from the inception of the firm throughout its life to its termination. The best choice is affected by everything concerning the firm and is different for each firm. This chapter called attention to how the proper choice is affected by just a few of the factors (1) which are present when the choice is made, (2) which appear in the operation of the business, and (3) which involve liquidation and termination.

The discussion in this chapter was general and dealt with basic principles. At this point, it may seem that there are so many advantages and disadvantages

of each form that it is impossible for the businessman to make a proper choice. The choice is, indeed, difficult, and broad generalizations cannot give the businessman the specific answers he needs. However, he can obtain that specific data by computing exactly what <u>his</u> tax would be under a variety of circumstances. He will usually want to have his professional tax advisers help with this task. Much of this report is devoted to illustrations of how such computations can be made. These illustrations do not show the mechanical details, but are condensed so as to emphasize what must be computed and the comparative effects which are revealed by the computation. There are many excellent manuals which set forth <u>how</u> to make the computations once one knows what he needs to compute.

CHAPTER III--FIRM A

EFFECTIVE TAX PLANNING IN THE CORPORATE FORM
Special Analysis: Non-taxable Transfer to a Corporation

This case study reviews the story of a business which has used good tax planning and reflects the typical handling of taxes in a small family corporation. The comparison of taxes under alternative forms of organization, which comprises the second section of the chapter, is especially important because it sets forth the basis of comparison for similar analyses in each of the other chapters.

The special analysis section provides a simple example of the tax-free method of transferring a business to a corporation. This procedure must be kept in mind if the more complicated principles which are demonstrated in later chapters are to be understood.

HISTORY OF THE FIRM

General

John Adams had operated his small business for several years before he decided to incorporate it in 1952. His primary reasons for incorporating were to obtain limited liability and to make it easier for the business to continue in the event of his death. The business was incorporated at the same time that he wrote his will and started planning his estate. While the business is small, it would provide sufficient income for his widow and minor children since the organization itself is not terminated by death of a stockholder.

When the business was incorporated, the stock was issued to Mr. and Mrs. Adams jointly with the right of survivorship.[1/] Since the value of the stock was under

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1/While this method was a sound choice in this instance, there are many situations when joint ownership is not desirable. Discussion of the advantages and disadvantages of joint ownership is beyond the scope of this study, but the authors wish to point out that joint ownership should not be used without first consulting an attorney who is familiar with probate procedures in the stockholder's state. Just because joint ownership is right for one person does not even mean that it is right for other members of the same firm.

$30,000, no gift tax was involved.

Adams kept the building in his name and rented it to the corporation. As will be seen later, this was helpful in keeping the tax as low as possible.

Financial History

Firm A has not changed much during the period covered by this study. This can be seen by examining the balance sheets in Table 1. These balance sheets show that Firm A has progressed satisfactorily but that no great expansion has taken place. The total investment in equipment is nearly three times the investment at the time of incorporation, so the balance sheets show that the plant has been modernized and kept up to date. Since retained earnings have grown slowly, and there are loans due to Adams, the corporation must have distributed most of the earnings. The corporation has occasionally borrowed from its stockholders rather than retain any substantial portion of earnings in the firm.

TABLE 1
FIRM A
CONDENSED, COMPARATIVE BALANCE SHEETS

	When Incorporated April 1, 1952		At End of Study Period March 31, 1960	
Assets:				
Current assets		$ 4,750		$ 7,500
Equipment:				
Cost	$10,500		$32,500	
Portion charged to expense (depr.)	-0-	10,500	17,900	14,600
Other assets				1,200
Total assets		$15,250		$23,300
Liabilities:				
Accounts payable and accruals		-0-		$ 6,000
Notes payable		$ 3,250		-0-
Total liabilities		$ 3,250		$ 6,000
Equity:				
Common stock	$12,000		$12,000	
Retained earnings	-0-	12,000	5,300	17,300
Total liabilities and equity		$15,250		$23,300

Having noted that Firm A has apparently distributed most of its earnings to Adams, income statements are needed to get to the heart of the story of the firm.

CONDENSED, COMPARATIVE STATEMENT OF EARNINGS AND TAX PAID c/

Corporation:	Fiscal Year Ended March 31							
	1953	1954	1955	1956	1957	1958	1959	1960
Sales	$86,600	$81,700	$84,500	$82,700	$75,600	$79,700	$87,400	$91,400
Cost of goods sold	42,900	37,000	39,500	37,600	34,000	34,700	35,700	38,200
Gross profit	$43,700	$44,700	$45,000	$45,100	$41,600	$45,000	$51,700	$53,200
Operating expenses	43,300	43,700	43,500	43,800	41,100	44,000	49,800	51,700
Net operating profit	$ 400	$ 1,000	$ 1,500	$ 1,300	$ 500	$ 1,000	$ 1,900	$ 1,500
Other income and expense	-0-	-0-	100	200	200	100	200	100
Net profit	$ 400	$ 1,000	$ 1,600	$ 1,500	$ 700	$ 1,100	$ 2,100	$ 1,600
Corporate tax paid	$ 128	$ 300	$ 476 a/	$ 434	$ 209	$ 344	$ 617	$ 473

Individual:	Calendar Year							
	1952	1953	1954	1955	1956	1957	1958	1959
Rent of building to Firm A:								
Rent charged	$ 2,462	$ 3,904	$ 3,538	$ 3,563	$ 3,297	$ 3,377	$ 3,619	$ 3,922
Expenses (inc. depreciation)	774	1,234	1,040	901	977	684	1,037	818
Net rental income	$ 1,688	$ 2,670	$ 2,498	$ 2,662	$ 2,320	$ 2,693	$ 2,582	$ 3,104
Profit from business for three months before incorporating	3,607							
Salary:								
John Adams	3,900	6,113	8,277	9,563	9,177	7,214	8,180	11,483
Mrs. Adams	75	504	403	269	448	380	494	414
Directors fees	30	30	60	30				
Interest on loan to Firm A		88	88	88	76	141	141	212
Dividends from Firm A (after exclusion)			195	490	195			
Other							16	47
Adjusted gross income	$ 9,300	$ 9,405	$11,521	$13,102	$12,216	$10,428	$11,413	$15,260
Individual tax paid b/	$ 1,520	$ 1,544	$ 1,860	$ 2,257	$ 2,041	$ 1,598	$ 1,690	$ 2,785

a/ Alternative tax saved $2.50.

b/ Copied directly from the owner's tax returns. As was pointed out on page 8, details of itemized personal deductions, exemptions and other details which are the exact figures from actual returns, and are held constant in the alternative computations, are omitted in order to help the reader concentrate on (a) data needed and (b) results. In this case, three exemptions were claimed, but itemized deductions were used some years and the standard deduction some years.

c/ "Figures on the income statement are rounded to the nearest one hundred dollars. Obviously, 30% of the accounting profit rounded to the nearest hundred dollars will not give the exact corporate tax. These are separate, selected bits of information. The exact Corporate adjusted gross income (not necessarily the accounting net profit) in 1960, for example, was $1,578.18 and the tax was $473.45.

Condensed earnings statements for both the corporation and for Mr. and Mrs. Adams for each year are summarized in Table 2. This table also shows the tax which was paid.

Firm A has distributed most of its earnings in the form of salary and rent rather than as dividends. So, the most significant part of Table 2 is the detail of Adams' earnings. This portion of the table shows that the firm has been returning an income of between $10,000 and $15,000 a year as payment for his investment of between $12,000 and $17,000 and for his work. The firm is therefore one of those successful small businesses which are one of the strengths of our country.

TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

Firm A would clearly seem to be one of those firms which Congress had in mind when it enacted the partnership-like tax option for small business corporations in 1958.[1/] The corporate form was chosen by Adams purely for business reasons. It would be unfortunate if this choice cost him substantial additional taxes. In order to determine the tax effect of his choice, the tax which would have been paid under four alternative forms of organization were computed. These computations are summarized in Table 3.

The first three columns summarize the earnings of the firm and of Adams combined, and the total tax paid. This data is summarized from Table 2, and is included here in order to summarize the data in a form which is easy to compare with the other columns in Table 3.

Partnership

The first alternative form is the partnership form. Since Mr. and Mrs. Adams file joint returns, the tax in the partnership form is the same as it would

[1/] See the quotation on page 2 in Chapter I.

TABLE 3
FIRM A
TAXES UNDER ALTERNATIVE FORMS OF ORGANIZATION

	Actual Transactions			Tax in Alternative Forms			
						Corporation	
Year	Total Sales	Total Net Business Income [a]	Total Tax Paid	Partnership[b]	Tax-Option Corp.	Optimum Planning[c]	No Planning[d]
1952	$ 86,600	$ 9,700	$ 1,520	$ 1,609	$ 1,520	$ 1,520	$ 1,701
1953	81,700	10,400	1,672	1,758	1,638	1,672	2,373
1954	84,500	12,900	2,160	2,213	2,077	2,160	3,662
1955	82,700	15,900	2,735	2,485	2,566	2,735	4,645
1956	75,600	14,100	2,475	2,140	2,376	2,475	3,184
1957	79,700	12,700	1,807	1,857	1,765	1,807	2,891
1958	87,400	11,500	2,034	2,195	1,988	2,034	4,731
1959	91,400	16,800	3,258	3,237	3,402	3,258	6,723
Total	$669,600	$104,000	$17,661	$17,494	$17,332	$17,661	$29,910

a/Includes net corporate income plus adjusted gross income of Mr. and Mrs. Adams less dividends.

b/The difference in tax between the partnership and the tax option form is due in part to the inclusion of the income of the corporate fiscal year in the partnership earnings. See note 1 below.

c/Same as tax actually paid since the firm was striving for optimum tax planning. Details of bonuses, interest, dividends, etc., can be ascertained from Table 2.

d/Assumptions:

1. Building was contributed to corporation along with rest of the assets in return for stock.
2. A flat salary of $500 a month was drawn.
3. The same cash withdrawals as in the actual operation are assumed except that all over $500 now becomes dividends.

have been had the firm continued as a proprietorship[1] and would have totaled $17,494. Since $17,661 was actually paid, the corporate form cost Adams the difference between these amounts or $167 of tax over the eight-year period. In his mind, the business advantages of the corporate form were worth this cost.

1/Since the corporation is on a fiscal year ending March 31, there are three months of extra income of the corporation included. However, since most of the corporate income is withdrawn as salary and interest, and since only the salary and interest received by Adams during the calendar year is included, there is almost no difference in total income taxed in each form. The corporate income for the year ended March 31, 1960, was only $1,578.18, so assuming ratable earnings each month, only $394.55 of extra earnings is included in the corporate forms.

Tax-Option Corporation

The partnership-like tax option election under Subchapter S was not available during most of this period. However, the tax which would have been paid had the election been available is tabulated in the column following the partnership column. For Firm A, the tax would have been virtually the same under this selection[1/] as it would have been in the partnership or proprietorship form. So, from the point of view of the amount of tax which would have to be paid, the tax-option election would have been wise for Firm A. Adams could then have had limited liability, continuity of operations could have been assured, and the lowest tax obtained. Other advantages and disadvantages of the election are discussed from place to place in this report.

Conventional Corporation with Optimum Tax Planning

The next to the last column in Table 3 tabulates the tax which would have been paid under optimum tax planning as that term was defined in Chapter I. Since Firm A has strived for optimum tax planning, the tax reflected in this column is the same as the tax actually paid. Reference to Table 2 will show that most of the income of the corporation was distributed each year, but that some income was left in the corporation. The firm used three methods to get income out of the corporation without the double tax which would apply to dividends: (1) Adams was paid a bonus each year based on a percentage of corporate profits, (2) the building was retained by Adams and was rented to the corporation for a per cent of gross receipts and (3) Adams occasionally loaned money to the firm and interest was paid on those loans.

Limitations which pertain to the use of such devices are discussed at various places in this report. It should be emphasized at this point, however, that the

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[1/] Most of the difference reflected in Table 3 is due to the factor discussed on the preceding page and in footnote b of Table 3.

firm must be careful to be sure that all such transactions are bona fide and that they are no more liberal than if non-stockholders were involved. Firm A has kept this in mind in doing their tax planning so provides an example of effective tax planning. They have used discretion and common sense, yet have kept the tax within about $50 of the tax in the partnership form each year. Note that they even paid small dividends in three years. It is not likely that the Internal Revenue Service would challenge their plan.

Conventional Corporation With No Tax Planning

The last column in Table 3 is labeled "No Planning." This does not mean that the procedures which result in the most tax were sought out in making the computations for this column. Rather, a typical method of operations was assumed. A salary of $500 a month is assumed and it is assumed that the building was contributed to the corporation instead of being retained by Adams and being rented to the corporation. The difference between the salary and rent actually drawn, less the building expenses paid by Adams, is treated as dividends. In other words, everything is treated just as actually happened except that some of the withdrawals are dividends instead of deductible items.

Conclusion

Since the total tax paid with "no planning" is $29,910 as compared with $17,661 under optimum tax planning, it appears essential that careful tax planning be carried out if businesses such as Firm A are not to pay far more than their fair tax when they choose the corporate form. Remember, however, that the lowest tax resulted in either the tax-option corporate form or the partnership form. If the amount of tax were the only factor involved, most small corporations which qualify would want to choose the Subchapter S tax-option. However, there are many disadvantages which sometimes more than offset the immediate tax saving. Many of these disadvantages are discussed and illustrated in later chapters.

SPECIAL FACTOR ILLUSTRATED BY THIS CASE

Problem Studied

This analysis probes the non-taxable transfer of Adam's proprietorship business to the corporation in exchange for the capital stock of the corporation. This transfer was typical of the way small corporations are commonly formed so provides an illustration of how the ordinary transfer should be handled. Unusual situations and other ways of transferring a business to a corporation are illustrated in later chapters.

Statutory Provisions

Our income tax laws have recognized almost from the start that no tax should be incurred just because a business is changed from one form of organization to another. As early as 1918 the exchange of securities in a reorganization, merger or consolidation of corporations was non-taxable. The contribution of property to a new corporation has been non-taxable since 1921.[1/] [2/]

Fundamental Requirement

The basic concept of a non-taxable transfer of a business to another form of organization has seldom been challenged in either the courts or in legislative action. The first important court case did not arise until 1934. In that year, one of the landmark cases of income taxation, Gregory,[3/] established the doctrine that the most essential requirement which must be met if a transfer is to be

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1/ Section 202(c)(3). See Seidman, page 789.

2/ Section 203(b)(4) 1924 to 1928, Section 112(b)(5) 1928 to 1954, and Section 351 since 1954. Tracing the committee and legislative reports reproduced in Seidman's works reflects the importance of this provision to our basic tax structure. Mertens also traces historical background of Section 351 on ¶ 20.45 et. seq.

3/ Helvering v. Gregory, 69 F(2d) 809 (CCA 2nd 1934), aff'd. 293 US 465, 79 L Ed 596, 55 SCt 266 (1935). This case was actually a case involving a reorganization, but the principles established seem to be equally applicable to Section 351 transfers.

See Merten's Law of Federal Income Taxation, ¶ 20.46, 20.47, 20.55 et. seq. for a comprehensive analysis of the background and effect of the Gregory decision.

non-taxable is the intent to continue or carry on in corporate form a venture or business which has previously been operated in some other form.[1/]

Specific Requirements

The present law governing transfer of a business to a corporation sets forth four technical requirements. If the transfer meets all four, the transfer is non-taxable. If the transfer does not meet any one or more of the requirements, the transfer is taxable. These basic requirements are:[2/]

1. Transfer of property,
2. In an exchange by one or more persons,
3. For stock or securities of a corporation,
4. Thereafter "controlled" by the persons involved.[3/]

Services are not property for purposes of the first requirement. The regulations[4/] insist on this in order to prevent taxpayers from taking stock in a corporation in payment for salary or professional fees and thereby avoiding the payment of tax on that salary. Similarly, the tax-free status can be disallowed if property of small value is transferred to the corporation in order to help other persons qualify.[5/] An example of this would be where a person who owned

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[1/]A former business as such is not required. Any property qualifies so long as it is thereafter devoted to business use by the corporation as opposed, for example, to a temporary transfer followed by distribution to the stockholders. Thus, a building which had formerly been rented could be contributed to a corporation which would use the building in operating a business. The transfer would be a non-taxable exchange if other requirements are met.

[2/]See Section 351 of the Code for precise provisions. For a brief discussion of Section 351, see Montgomery's Federal Taxes, 18-6; CCH Federal Tax Course, ¶ 1619; Prentice-Hall Federal Tax Course, ¶ 1405.

[3/]Control is defined in Section 368(c) of the Code and Section 351 incorporates that definition by reference.

[4/]Sec. 1.351-1(i).

[5/]Reg. Sec. 1.351-1(ii).

a sizable portion of the stock of a corporation transferred a desk or a delivery truck to the corporation for the sole purpose of meeting the control test described in the next paragraph.

The control test is met if the persons who made the transfer own 80 per cent of the corporation after the transfer. This means both 80 per cent of the voting stock and 80 per cent of all other stock.[1/] This requirement is often the most difficult one to meet. Similarly, when a firm wants a transfer to be taxable rather than non-taxable, the easiest way to make it taxable is often to be careful that the persons transferring the property do not own 80 per cent of the corporation. If they do not, the transfer is taxable.[2/]

The control test is not measured on the day of the transfer but within a reasonable time thereafter.[3/] So, when two or more persons are transferring property to a corporation, one might make his transfer one day and the others a week later. Similarly, a transfer will be non-taxable even though the transferees own less than 80 per cent of the corporation if they acquire 80 per cent ownership shortly thereafter. The 80 per cent test applies to the aggregate interest of all of the persons transferring property to the corporation in connection with one plan or agreement which is completed within a reasonable time.

[1/] Reg. Sec. 1.351-1(a)(1). Also, see footnote 3 on page 37.

[2/] There are other ways of disqualifying a transfer for tax-free treatment. See, for example, Wood's remarks at the Twentieth Annual Law Institute at the University of Tennessee College of Law which was reported as part of a symposium issue of 27 Tennessee Law Review (Winter, 1960) page 189. Three suggestions included there were (1) Have one or more of the transferors receive property in addition to stock or securities of the corporation, (2) Have one or more of the transferors receive 21 per cent or more of the stock in exchange for services, or (3) Transfer property to the corporation subject to indebtedness in excess of the basis of the properties transferred. Some of these procedures make the transaction fully taxable and some only partly taxable.

[3/] Reg. Sec. 1.351-1(a)(1).

Prior Requirement

Between 1924 and 1954, there was one additional test which had to be met--that the proportionate interest of each participant be substantially the same in the corporation as it was in the property before the transfer. That requirement was deliberately omitted from the 1954 Code. The present law provides that disproportionate division of the stock of the corporation does not disqualify the transfer for non-taxable treatment, but notes instead that a gift, payment for services, or other taxable transaction may also be involved.[1/]

Exception

The basic rule provides that the persons transferring property to the corporation must receive only stock or securities of the corporation. However, there is an in-between ground wherein the law allows some deviation. This occurs when an exchange meets all of the requirements except that some cash, short-term notes or other property is received in addition to stock or securities of the corporation. When this happens, the transfer is technically taxable, but is recognized only to the extent of the money received plus the fair market value of the other property.[2/]

[1/] The intent of Congress is reflected in Senate Report No. 1622, 83rd Congress, 2nd Session, pages 264-5: "In any case in which the stock and securities received are not in proportion, the transaction will be treated as if the stock and securities had first been received in proportion and then some of such stock and securities have been used to make gifts, to pay compensation, or to satisfy obligations of any kind." For a simple example of disproportionate division of stock giving rise to taxable income, see "Taxable Income Resulting from Disproportionate Issuance of Stock," editorial comment in Tax Clinic, 109 Journal of Accountancy (June, 1960) p. 68.

[2/] Code Sec. 351(b).

Basis of Property Received

When a non-taxable transfer of property is made to a corporation, the basis[1] of the property remains the same as it was in the hands of the person who transferred it.[2] For example, if land which cost $10,000 was transferred to a corporation in a non-taxable exchange, the corporation has to treat that land as costing $10,000 regardless of the amount of stock which was issued for the land and what it was worth. Thus, if the land was really worth $25,000 at the time of the transfer (so $25,000 of stock was issued for it), the corporation still has to treat the land as having cost $10,000. Similarly, if the land were worth only $1,000 (so $1,000 of stock was issued), the corporation would nevertheless have to treat the land as having cost $10,000.[3]

1/ The word "basis" is universally used in tax literature to mean "basis for gain or loss." In their 1961 Federal Tax Course, Commerce Clearing House explains the meaning of "basis" as follows (page 55): "The word 'basis' has a special meaning for income tax purposes. It is used mainly in determining the amount of gain or loss on sale of property or in computing depreciation. It represents what the property cost the taxpayer, actually or constructively, but is of broader meaning than the term 'cost.' . . . The 'basis' (adjusted) or property is deducted from the 'amount realized' to find the gain or loss on its sale. If the property was acquired by the taxpayer through a purchase, the basis is the cost, except in special circumstances, such as the conversion of the property from personal to rental or other business purposes, in which case the basis for loss and for depreciation may be different than the basis for gain. Usually, however, the basis for the depreciation deduction is the same as the basis for gain. If the property was not acquired by purchase, but was acquired as gift property, inherited property, received in an exchange, etc., special rules apply in finding the basis."

2/ Code Section 362.

3/ This is, of course, for tax purposes only. The firm's accounting records will still show the land at its cost to the corporation in terms of the value of the stock issued. Thus, in this example, the land would be carried at $25,000 in the first instance and $1,000 in the second instance.

This points up the fact that for some specific purposes, businesses have to keep two sets of books--one for accounting and financial reporting, and one for income tax. There are numerous instances where the tax rules are not acceptable for accounting purposes and vice versa. In recognition of this, the corporation tax return even has a schedule where the accounting and tax records are reconciled (Schedule M). This is, of course, a very different sort of thing than the popular conception of two sets of books--one accurate and one inaccurate.

Summary

The rules pertaining to non-taxable transfers of property to a corporation may seem complicated at first encounter, but are easy to understand if they are applied to a specific situation. So long as the intent of the parties is to continue an existing business or put existing property to business use, and so long as the four basic statutory requirements are complied with, the transfer is non-taxable. The next few paragraphs demonstrate just how easy it was for Firm A to make the non-taxable transfer.[1/]

Specific Application to Firm A

Adams believed that the book value of the assets of his proprietorship business was close enough to their fair market value that he was willing to accept stock of the corporation for their book value. The corporation did not take over the accounts receivable or, as was previously noted, the building. The corporation did take over the notes which were owned in connection with the business.

The first step which was taken was to tabulate the book value of the items which were to be contributed to the corporation. They were:

Inventories (at cost)	$ 4,090.56
Equipment (cost less accumulated depreciation)	10,476.17
Prepaid expenses	264.37
Total assets	$14,831.10
Current liabilities to be paid by the corporation	3,250.00
Net assets to be transferred	$11,581.10

Adams and his advisers decided to have the corporation issue 120 shares of $100 par common stock to Adams for these assets. Although it was not necessary

[1/] This does not mean that there are never serious problems. For a comprehensive analysis of the application of Section 351, see Bittker, "The Corporation and the Federal Income Tax: Transfers to a Controlled Corporation," 1959 Washington University Law Quarterly, (Feb., 1959), starting on page 1.

All of the standard, full-size tax services and tax encyclopedias discuss Section 351 and cite cases which have been decided on technical points. The professional tax adviser should study one or more of these services carefully before actually making a non-taxable transfer for his client. This study is intended to explain fundamentals to the businessman, not to provide final technical answers for the professional practitioner.

for tax purposes, they decided that it would be desirable to have the accounting cost and the tax basis of the assets be the same. This was accomplished very simply by having Adams contribute $418.90 of cash to the corporation along with the assets tabulated on the preceding page. The opening balance sheet of the corporation was then exactly equal to the tax basis. This eliminates a great many complications in later years and is always desirable when it can be achieved easily. The opening balance sheet is summarized in Table 1, but is given below in detail to show exactly how the cash contribution made the net assets equal the stock issued:

Cash	$ 418.90
Inventory (at cost)	4,090.56
Equipment (at cost to the corporation)	10,476.17
Prepaid expenses	264.37
Total assets	$15,250.00
Notes payable	$ 3,250.00
Common stock (120 shares of $100 par)	12,000.00
Total liabilities and equity	$15,250.00

This transfer was simple, yet meets all of the requirements for a non-taxable transfer of property to a corporation.[1/] Most instances are nearly this simple if the fundamentals are just kept in mind.

[1/] The only complicating factor in the instance of Firm A is the fact that the stock received was placed in joint ownership with Mrs. Adams. It is possible that, except for a relief provision, this could have disqualified the exchange since Adams did not control the corporation immediately after the transfer. However, Section 267 of the Code provides constructive ownership rules which presumably apply to Section 351 through reference to Section 368, although an exact statement to that effect was not located in the research for this paper. Under these rules, stock held by a taxpayer's wife and certain other members of his family are deemed constructively held by him for purposes of determining control. If this interpretation is correct, Adams constructively owned all of the stock of the corporation so the transfer was non-taxable.

Since 1954 this complication is not as significant since a disproportionate division of stock does not disqualify a transfer for tax-free status. In any event, Adams probably made a gift to his wife, but, since no prior gifts of over the annual exemption had been made, and since the value of half of the stock was clearly less than the statutory lifetime exemption, no gift tax was involved. In a larger business handled in the same way, there would likely be gift tax due.

SUMMARY AND CONCLUSIONS

This chapter has reviewed a typical small corporate business which has followed good tax planning. Even with this good tax planning, taxes were higher than they would have been if the firm had been operated as a proprietorship or as a partnership with the owner's wife. The firm was incorporated in order to attain business advantages and the owners feel that the extra tax was a small price to pay for the corporate advantages.

The partnership-like tax option election under Subchapter S was not available during most of the period covered by this study. Had it been available, and had the firm elected this method, the tax could have been the same as in the partnership form, yet the business advantages of the corporate form could have been preserved.

If a typical method of operations (wherein the entire business is contributed to the corporation, a fairly high salary drawn each month, and additional withdrawals are in the form of dividends) had been followed, total tax would have been considerably higher than under the optimum tax planning which the firm employed. It seems, therefore, that careful tax planning is essential in the conventional corporate form if a small business is not to pay far more than its fair tax. The tax planning employed by Firm A included three features: (1) a bonus based on profits was paid to Adams each year, (2) the building was retained by Adams and was rented to the corporation for a percentage of gross receipts, and (3) interest was paid on loans from Adams.

The special analysis section of this chapter demonstrated exactly how a nontaxable transfer of a business to a corporation can be made. Although this is a simple procedure, all of the statutory requirements must be precisely complied with, or the transfer is taxable. Underlying all of the statutory provisions is the basic requirement that the intent must be to continue to operate a business in the corporate form.

CHAPTER IV--FIRM B

SALE OF A PORTION OF A PROPRIETORSHIP TO A RELATIVE
Special Analysis: Seven Methods of Sale and the Problems Inherent in Each
Qualification for the Subchapter S Partnership-Like Tax Option

This chapter is especially significant to small businessmen because the story of Firm B is typical of that of many healthy small firms which are often regarded as the backbone of our economic system. Specifically, it is the story of a man who purchased a run-down business because it could be purchased with the limited amount of capital he had, and who then, through long, hard hours of work and sacrifice by himself, his wife and family, built the business into a sound and growing firm. He now wants to sell an interest in the firm to one of his sons at a price which is fair and which will give him and his wife credit for the work and sacrifice they have put into building the business into its present state.

Federal income taxes have made it extremely difficult to make this type of sale. The problem demonstrated in the special analysis section of this chapter for Firm B are the same problems which will be faced by any person who wishes to sell a portion of his business to a close relative. By studying the problem in terms of Firm B, the findings can be specifically demonstrated instead of being merely discussed in general terms.

Since the relationship of father and son is a key factor, hypothetical names are not used. The owners are simply referred to as "the father" and "the son."

HISTORY OF THE FIRM

General

The method by which Firm B was formed and has grown has an important bearing on the significance of the tax burden under alternative forms of legal organization. A review of the history of the firm is therefore desirable.

The business operated by Firm B was purchased in February, 1953, from the founder of the business. The founder had not been making needed repairs nor keeping the plant modernized. He had made little effort to attract new customers and had doubtless been living out of the capital of the business. Finally, he had to do something. He was advanced in years, so sold the business to Firm B and retired.

The new owner of Firm B paid only $10,000 for the business and an option to purchase the buildings. He knew that his first tasks would be to repair the machinery and to start attracting new customers. He also knew that he would have to replace the machinery with more up-to-date items as rapidly as possible. However, the purchase gave him an opportunity to own a business. He realized that he and his family would have to make up for the lack of capital with long, hard hours of work. They operated the business during regular hours then spent evenings, Sundays, and holidays repairing the machinery and plant.

They sold their home to get part of the purchase price of the business and borrowed the balance from his brother, who owned the same kind of business in another town. This brother gave them considerable sound advice and guidance during the first years of operations and continues to advise them whenever unusual problems arise.

Financial History

Much of the history of the business is reflected in the comparative financial statements of Tables 1 and 2. Amounts are rounded to the nearest hundred dollars for easier comparison, but more detail is shown within classifications than in the other case studies because changes in these details are an important part of the history of the firm. For example, note the steady decrease in accounts payable.

The earnings reflected in Table 2 are computed without including salaries to the owner or his wife in expenses. In other words, the net profit is regarded as their reward for their work, capital investment, risk taking, and management. This is the way most small businessmen think of profits.

TABLE 4
FIRM B
CONDENSED, COMPARATIVE BALANCE SHEETS

	Balances as of December 31							
	1952	1953	1954	1955	1956	1957	1958	1959
Current Assets:								
Cash		$ 100	$ 100	$ 600	$ 2,300	$ 1,700	$ 1,700	$ 1,800
Receivables		2,500	3,300	3,700	3,900	4,500	5,300	5,200
Supplies	$ 300	900	1,200	1,400	900	1,000	1,300	1,400
Prepaid Expenses		200	100	100	100	200		300
Total cur. assets	$ 300	$ 3,700	$ 4,700	$ 5,800	$ 7,200	$ 7,400	$ 8,300	$ 8,700
Property & Equip.	10,000	10,300	11,100	9,200	10,000	9,100	16,100	16,500
Other Assets		100	100	100	200	200	200	200
Total assets	$10,300	$14,100	$15,900	$15,100	$17,400	$16,700	$24,600	$25,400
Current Liab.:								
Notes & contracts		$ 2,300	$ 2,700	$ 1,600	$ 1,100	$ 2,000	$ 1,200	$ 3,200
Accounts payable		3,500	3,100	2,300	1,100	1,600	3,500	3,600
Accrued expenses		400	800	1,100				400
Total cur. liab.	$	$ 6,200	$ 6,600	$ 5,000	$ 2,200	$ 3,600	$ 4,700	$ 7,200
Long-term Debt	5,700	6,100	5,700	6,800	8,600	6,100	11,600	6,700
Total liab.	$ 5,700	$12,300	$12,300	$11,800	$10,800	$ 9,700	$16,300	$13,900
Owner's Equity	4,600	1,800	3,600	3,300	6,600	7,000	8,300	11,500
Total liab. & equity	$10,300	$14,100	$15,900	$15,100	$17,400	$16,700	$24,600	$25,400

Large withdrawals were made in 1957 to make a down payment on a house.

Since fixed assets are shown net (after deducting accumulated depreciation) in Table 4, equipment acquisitions are not readily seen, yet are an important part of the history of the firm. The cost of the assets and the accumulated depreciation for each of the balance sheets in Table 4 do reflect that information, and are as follows:

	Balances as of December 31							
	1952	1953	1954	1955	1956	1957	1958	1959
Cost	$10,000	$11,500	$13,800	$13,800	$16,900	$18,800	$29,600	$31,800
Accumulated dept.		1,200	2,700	4,600	6,900	9,700	13,500	15,300
Remaining cost	$10,000	$10,300	$11,100	$ 9,200	$10,000	$ 9,100	$16,100	$16,500

The plant has been repaired and modernized until it is becoming an efficient operating unit. Much of the repair was done by the owner and consisted of reworking the machinery and rearranging it so as to improve plant layout and efficiency.

The cost of repair parts was not high and was included in expense. The plant is, therefore, worth considerably more than book value. The owner's real equity, based on market value, has accordingly increased more than is reflected in the balance sheet.

Taxes Paid as Proprietorship

Earnings of Firm B and the taxes paid by the owner are summarized in Table 5 below. This table shows only key items.[1/]

TABLE 5
FIRM B
EARNINGS AND FEDERAL INCOME TAXES PAID BY ITS OWNER UNDER PROPRIETORSHIP FORM OF ORGANIZATION

	Total	1953	1954	1955	1956	1957	1958	1959
Sales	$358,600	$36,900	$38,800	$42,300	$55,800	$57,500	$62,700	$64,600
Cost of sales	186,900	25,900	22,800	23,500	26,800	27,500	29,900	30,500
Gross profit	$171,700	$11,000	$16,000	$18,800	$29,000	$30,000	$32,800	$34,100
Operating Exp.	121,300	10,100	12,900	14,100	19,200	20,300	22,900	21,800
Net op. profit	$ 50,400	$ 900	$ 3,100	$ 4,700	$ 9,800	$ 9,700	$ 9,900	$12,300
Other earnings of owner	1,200	1,100	(200)		100	(100)	200	100
	$ 51,600	$ 2,000	$ 2,900	$ 4,700	$ 9,900	$ 9,600	$10,100	$12,400
Income tax paid by owner	$ 7,736	$ 12	$ 151	$ 482	$ 1,622	$ 1,590	$ 1,649	$ 2,230

TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

The same comparison of tax under alternative forms of organization was made for Firm B as was made for Firm A in Chapter III. Since the computations were discussed in detail in connection with the study of Firm A, it is not necessary to outline the procedural steps again. Instead, the final results are summarized in Table 6. The more important assumptions which were made are noted in the footnotes to that table.[2/]

[1/] As a point of interest, processing costs have been reduced from 66.5% in 1953 to between 46 and 47 per cent in 1956 and later years. Most of this reduction came in labor costs as plant layout was improved, supplemented by changes wherein the machines were put in good working order and the most inefficient machines were replaced.

[2/] As was noted on pages 8 and 31, details of computation are not included in this report. However, if the readers should try to approximate this computation of taxes shown in Table 6, do not forget the other earnings of the owner shown in Table 5. These must be held constant in all computations for this firm if a valid comparison is to result.

Note that the optimum tax planning formula simply assumed that the salary in the corporation was the same as the withdrawals in the proprietorship. These withdrawals were almost exactly the same as the net earnings of the firm during the first five years of operation, so have the effect of withdrawing all of the profit as a deductible item. This is, of course, the goal in the small corporation where the owner's tax bracket is below the 30 per cent beginning corporate bracket. By the end of the fith year (1957) the tax in the corporate form with this tax planning would have been just $36 more than was paid in the proprietorship form. However, during the two most recent years, all of the profit was not withdrawn. Approximately $1,300 was left in the firm in 1958 and $3,000 in 1959. The computations for this "Optimum Tax Planning" column therefore reflect taxation of these amounts at the corporate rate of 30% instead of at the owner's 22% rate.

The withdrawals in the optimum tax planning form were greater than the net profits in several years. So, net operating losses were created which were carried forward. Thus, the net profit for 1953 after deducting the assumed salary is a loss of $2,800. Smaller losses appear in the detailed computations for 1954 and 1955. In 1956 and 1957 there are profits before the net operating loss carry-forward. By the end of 1957, the losses were used up except for $200 which is carried forward to 1958.

In regard to the fact that the tax would have been nearly the same in the corporate form with optimum tax planning as in the proprietorship form during the first five years, three points sould be kept in mind. First of all, the tax would not be this close if the owner's income fluctuated so much that the owner would be in different tax brackets each year. Second, and more significant, is the fact that in the corporate form it was necessary to pay individual tax on the "salary" in the early years when working capital was at a premium. The tax would have been paid in the years when it was most difficult to pay, eating into the working capital at a time when maintaining even the very minimum working capital

was a major problem. Third, net operating losses can be carried forward only five years.[1] Had the corporation not started making sizable profits as soon as they did, the loss in the early years might have been lost as a carryover.

TABLE 6
FIRM B
COMPARISON OF TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

	Actual Transactions			Tax in Other Forms			
						Conventional Corporation	
Year	Sales	Total Net Income	Tax Paid	Proprietorship	Tax Option Corp.	Optimum Planning[a]	No Planning[b] [c]
1953	$ 36,900	$ 900				$ 600	$ 600
1954	38,800	3,100	$ 200	$ 200	$ 200	300	500
1955	42,300	4,700	500	500	500	500	500
1956	55,800	9,800	1,600	1,600	1,600	1,000	800
1957	57,500	9,700	1,600	1,600	1,600	1,500	2,700
1958	62,700	9,900	1,600	1,600	1,600	1,700	2,800
1959	64,600	12,300	2,200	2,200	2,200	2,400	3,600
	$358,600	$50,400	$7,700	$7,700	$7,700	$8,000	$11,500

[a]This computation assumes that salaries are the same as actual withdrawals from the proprietorship. The computations include resulting net operating loss carrybacks and carryovers to 1956 and 1957.

[b]This computation assumes that a salary of $400 a month was paid to the owner each month and that the rest of the withdrawals (to equal actual partnership withdrawals) were taken as dividends.

[c]Under the assumptions set forth in footnote "b" the corporation shows a net operating loss in 1953, 1954, and 1955. These are used as a net operating loss deduction in 1956.

The tax which would have been paid by Firm B under the alternative forms of organization and the three qualifications outlined in the preceding paragraph indicate that there is truth in the often heard axiom, "Operate as a proprietorship or partnership until profits are assured." The wisdom of this is demonstrated even more conclusively in Chapter VII which studies a firm which sustained huge losses in its first year.

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[1]Net operating losses are analyzed in Chapters VII and X.

The tax which would have been paid as a tax-option corporation is exactly the same as the tax which was paid as a proprietorship. This suggests that the axiom might be changed to say, "Operate as a tax-option corporation, proprietorship or partnership until profits are assured." By using the tax-option corporate form, Firm B could have retained the tax advantage of the proprietorship form and, in addition, have obtained the business advantages of the corporate form. However, as will be pointed out repeatedly in this study, there are hidden dangers in the tax-option election which must be carefully ferreted out before that form is chosen. Where there are no hidden snags, the election provides an ideal answer for a business in Firm B's position.

The higher total tax in the corporate form when no careful tax planning is done (right-hand column of Table 6) is to be expected because there is double taxation of dividends. The dividends in this computation are the difference between actual withdrawals in the proprietorship and an assumed salary of $4,800 a year, and total $13,535.92. The difference in tax between the proprietorship and this corporate form (rounded to the nearest hundred dollars) is caused by:

Corporate tax on income distributed as dividends (30% of $13,535.92)		$4,100
Tax on earnings retained in the corporation are taxed at 30% instead of at the owner's lower individual rates		400
Gross increase in tax		$4,500
Less Reduction of individual tax of owner:		
From $50 a year dividends received exclusion	$100	
Dividends received credit (4% of taxable dividends)	600	700
Net difference in tax		$3,800

The above tabulation shows that the dividends exclusion and the dividends received credit do provide some significant relief from double taxation.

The concept of "no tax planning" does not, as has been emphasized previously, mean that the computations seek the highest tax. It means, instead, that a typical way of operating is assumed. In this instance, a salary of $400 a month is a fair approximation of the salary the firm would have set had they been incorporated.

SPECIAL FACTORS ILLUSTRATED WITH THIS CASE

Nature of Problem Studied

The special problem analyzed in this section is a very real problem for many small businesses. The son of the owner has been working in the business as a regular employee since he finished school and his military service. The intent of both the father and the son is that the son is to work as a salaried employee until he is sure whether or not he wants to stay in the business permanently. If he decides that he does want to remain with the firm, they want to work out some method by which he can purchase an interest in the firm. Both recognize the immense amount of work and sacrifice that has gone into building the business and agree that, since the owner has other children, the son is to pay a fair, sound price for any interest he purchases. This is the same problem that is faced by many small businesses, so this study of Firm B should have wide applicability.

Several organizational and procedural possibilities suggest themselves, but all have tax disadvantages. The relative advantages and disadvantages of several plans are investigated in the remainder of this section. All of the plans revolve around the form of organization of the business at the time the plan is put into effect.

Plans Using the Partnership Form

A simple plan would be to sell an interest to the son and form a partnership. However, even that could be done in more than one way. Four possible methods are to be examined.

Sell Part of the Present Owner's Interest:

The present owner could sell part of the business to his son. Each would then contribute his part of the business to a partnership. The son has no income other than his earnings from the business, but could use part of them to pay his

father for the interest purchased.

As was pointed out in the Financial History section, the value of the firm is higher than the book value, both because improvements have been made which were charged to repairs and because there is a growing list of satisfied, regular customers. The sale to the son would, therefore, result in a gain which would be taxed as a long-term capital gain to the father,[1/] unless there is something in the father-son relationship which might prevent this treatment. The son would, of course, have no deduction at the time he purchased the interest because he is purchasing capital items.

The gain or loss to the father would be computed on the basis of gain or loss on the sale of individual assets. This rule is one of long standing.[2/] In order to demonstrate just how the profit on such a sale is computed, it is assumed that the son purchased a one-third interest in the firm on the basis of $25,000 valuation for the entire firm, on December 31, 1957.[3/] The firm will pay the long-term debt as it comes due. The computation of the gain based on the balance sheets in Table 4 is summarized in the following tabulation:

[1/] Under the provisions of Code section 1231. See the discussion of this section of the Code on page 16 of Chapter II. Note, however, the possibility of denial of capital gain treatment which is pointed out on page 54.

[2/] The rule is well summarized in Long, "Points to Be Considered in Dividing an Existing Business," <u>Fifth Annual Institute on Federal Taxation</u> (November, 1947) page 731: "A business conducted as a sole proprietorship is not recognized under our tax law as a separate juristic entity. For tax purposes such business is an aggregation of many separate and distinct assets, each of which must be examined and classified as to capital and non-capital assets so that upon a division of such a business, particularly by a sale of a part or interest therein, the gain or loss may be properly determined. . . ."

[3/] December 31, 1957, is used instead of December 31, 1959, in order to make the demonstration on the next page more emphatic. The amount of profit reflected in the demonstration would be less if 1959 figures were used so it would be more difficult for the reader to visualize the principle.

		Total Business	One-Third Sold
Selling price of the assets		$25,000	$8,333
Portion sold at cost: 1/			
Current assets	$7,500		
Current liabilities	3,600		
Net working capital	$3,900		
Deposits (other assets)	200	4,100	1,367
Selling price of fixed assets		$20,900	$6,966
Basis of fixed assets		9,000	3,000
Profit on sale		$11,900	$3,966
Long-term capital gains deduction (50% of net)			1,983
Taxable portion			$1,983
Tax at 22 per cent (owners' current bracket)			$ 436

Before the father in Firm B, or any businessman in his position, should go ahead with a sale of a portion of the business to a member of his family or a close relative, there are several ramifications which must be investigated carefully.

First, working capital.--Since the father's only source of income is from the business, he would have to withdraw $436 cash from the firm to pay the tax on the sale. This would cut into working capital.

Second, split basis of assets.--If the son purchases a one-third interest in the business, each asset will have two different bases--2/3 of each asset will have a basis carried over from the father and 1/3 would have as a basis the price paid by the son. For example, an adding machine which has an adjusted basis to the father of $60 would have a basis in the partnership of:

2/3 of the father's basis	$40
1/3 at the price paid by the son for a 1/3 interest (1/3 of $25,000/9,000 X $60)	55
	$95

This split basis is confusing to say the least. In addition, there is the

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1/ Since the business is being sold at its fair market value, it must, from a practical viewpoint unless there are special circumstances, be assumed that the value of these items is the same as their book value (unless, of course, the books do not reflect the allowance for doubtful receivables, proper inventory valuation, etc.). Each asset must, as observed on page 52, be considered separately, so, if these are sold at their book value, the remainder must be the value of the fixed assets. It is assumed that the sale price of $25,000 was for the fixed assets and net working capital.

problem of how to compute depreciation and allocate it to each partner. The possibilities of allocating depreciation on a different basis than ordinary income and expense will be explored in Chapter V.

Third, goodwill.--There is a possibility that part of the sales price to the son is for goodwill. If that is so, no depreciation is allowable on the goodwill portion.

Fourth, denial of capital gains treatment.--Some writers indicate that the sale to the son would not be subject to capital gains rates, but would, instead, be taxed as ordinary income to the father, at least if the son is a minor.1/ Other writers indicate that the denial of capital gains treatment occurs only when the sale is between husband and wife or between a controlled corporation and the taxpayer. They bring children and grandchildren into the picture only in determining whether or not the corporation is controlled.2/ 3/

If one reads the applicable sections of the Code (quoted in the footnotes to the preceding paragraph) literally, it is hard to see how the prohibition of capital gains on a sale at a profit to a son applies. However, when one reads the intent of the provision, it is possible that Congress intended to bring such a sale within the prohibited provisions when a stepped-up basis of fixed assets results in a partnership. The committee report submitted when the partnership

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1/See, for example, Paul A. Phillips, "How to Handle Transactions Between Related Taxpayers," PH Tax Ideas ¶ 8018.4.

2/Most writers are cautious and simply repeat the wording of sections 707 and 267(c) and the corporate sections 1239, 368(c), and 267(c). No article was found during the research for this report where a direct comment was made on the sale to a son who was of age.

3/Capital gains treatment is clearly denied when a sale is between spouses or between an individual and his controlled corporation or partnership, under the provisions of the sections quoted in the preceding footnote.

section was presented to Congress[1] indicates that the purpose of the limitation is "to prevent tax avoidance . . . (by) increasing the basis of property for purposes of depreciation."

On the other hand, there is some reason to believe that Congress intended to limit the provisions to those relationships mentioned--between spouses and between individuals and firms which they control.[2]

It seems most likely, therefore, that the sale of assets to the son is subject to capital gains rates. This is almost sure when the son is not a minor. However, the comments by eminent authorities to the effect that such treatment might be denied should not be taken lightly, and the area should be watched for future development and clarification by the courts or administrative rulings.

Clearly, a sale of assets to the partnership after it is formed would not qualify for capital gains treatment.[3]

Before leaving this point, it is well to note that, while the partnership rules were new in 1954, they are broader than the corporate rules in that the partnership rules apply to any property which would not be a capital asset in the hands of the transferee rather than just to depreciable property as in the case of corporations. Where there are sizable amounts of real property, for example,

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[1]Reproduced, among other sources, at ¶ 3931 of <u>1955 Standard Tax Reports</u> by Commerce Clearing House, Inc.

[2]For example, the <u>Federal Tax Course</u> by Commerce Clearing House states at ¶ 1731: "Note that this provision (section 1239 which denies capital gains treatment on sales to a controlled corporation) applies only to depreciable property, and then only to transfers between husband and wife, and between a stockholder and a corporation which he controls. In this respect it is to be distinguished from the prohibition against deduction of losses on sales to related interests under Code Sec. 267." The corresponding partnership provision refers directly to Sec. 267 in setting rules for constructive ownership, but specifically excludes part (c) of that section from the definition.

[3]This is to be contrasted with the situation in Chapter V where the partnership is not controlled by the seller and his family.

this could point toward using the corporate form rather than the partnership form.[1/]

<u>Fifth, family partnership limitations</u>.--It is entirely possible, although there is no direct statement in the law relating to a sale to a relative before formation of a partnership, that the sale of a portion of the business to the son could be brought within the provisions of the family partnership rules. These family partnership rules were set up to close a "loophole" whereby property was given to members of the family. This allowed the income to be split between several persons thus getting the income taxed at lower rates, yet, since all of these persons are members of the family, the donee still, for all practical purposes, controlled the business.[2/] Under certain circumstances, sales are now treated as gifts. This rule is an extension of the family partnership rule and was intended to close the loophole completely.[3/]

It would seem that a sale of a portion of the assets to the son of the owner of Firm B would come within this rule. If it does, the firm would then be subject to the family partnership rules. Basically, these rules require that salary must be paid for services rendered to the partnership and the division of the balance of the earnings must bear a direct relationship to the amount of capital. Thus, an arbitrary 1/3 and 2/3 or 2/5 and 3/5, or similar division of profits would not be permitted.[4/]

[1/] See Phillips, supra, p. 54.

[2/] See the general discussion in Chapter II, p. 18.

[3/] The rule is contained in section 704(e)(3), which reads: "(3) . . . For purposes of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The 'family' of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons."

[4/] For a discussion of the effect of bringing the transaction within the family partnership rules, see Godert, "Basis Problems of Partners and Partnerships," <u>Proceedings of Fifth Annual Tulane Tax Institute</u>, p. 233-4.

This inflexibility of division of earnings when a firm is brought within the family partnership rules destroys one of the advantages of the partnership form.

In conclusion, all that can be stated definitely about having the son purchase a part of the business from the father and then contribute it to the partnership which is thereafter formed is that the whole tax treatment is unsettled. This uncertainty in the tax picture is a significant factor which adversely affects the choice of the partnership form when a son, or any other close relative, is to be sold an interest in the firm. Two possibilities, neither of which is certain, which are especially serious and must be borne in mind are (1) that the father might be denied capital gains treatment on the sale, and (2) that the division of profits might be restricted to those permissible under the family partnership rules. The family partnership rules were not intended to apply to this type of situation, but they may inadvertently have been so worded as to do so.

The Son Purchases New Equipment and Contributes It to the Partnership

One way to avoid the confusion in the tax consequences of a sale to a close relative is not to sell an interest, but rather, to let the relative make a contribution to the partnership. In the instance of Firm B, working capital is needed and new equipment is being purchased as rapidly as possible. The son could purchase new equipment instead of having the firm purchase it. He would then contribute the equipment to the firm in return for a capital interest. Assuming that the equipment is purchased on credit, the obligation would be the son's and he would pay the notes. This would be no more difficult than paying the father for an interest.

Under a plan of this type, the division of income would have to be on some basis other than in proportion to capital. Likely some formula along the lines of allowing a salary to each, allowing interest on average capital (based on actual

value rather than the tax basis) and the remainder divided equally would be equitabl

Partners can divide profits almost any way they wish and the Internal Revenue Service will not interfere so long as the profits are actually divided as stated, and so long as the family partnership rules do not apply.[1/] Crediting the income share on the books is sufficient if the books are properly kept and are used as the real record of capital. The partnership agreement is controlling.[2/]

In conclusion, letting the son contribute the new equipment should accomplish the purpose of the owner and his son in bringing the son into the business without a tax penalty. However, this procedure is not always financially possible if the son has no credit status.

Sell Certain Assets to the Son:

A plan involving parts of the two preceding ones would be for the father to sell certain specific assets to the son rather than to sell a portion of the entire business. The son could then contribute these specific assets to the new partnership.

This plan might get a stepped-up basis for the assets which were sold to the son and contributed by him. If the assets which were sold to the son were ones which were nearly depreciated on the father's books, this stepped-up basis could result in substantial tax savings over a period of time. The father would, of course, pay tax on the gain at the time of sale, but probably at capital gains rates.[3/]

[1/] Since the son is getting his interest by contributing property rather than by purchasing a portion of his father's interest or by gift, the partnership would not be under the family partnership rules.

[2/] Code section 704

[3/] See the discussion of taxable or non-taxable exchange in Chapter II, page 20. The same reasoning applies here.

The two possible snags mentioned in connection with the first plan may also apply here. First, the father might be taxed at ordinary rates rather than at capital gains rates. Second, the firm might come under the family partnership provisions on the distribution of income. The chances are that neither of these possibilities apply to Firm B, but one cannot be sure. They are always present as a threat thereby providing a tax deterrent to another sound plan from an organizational viewpoint.

Form a Partnership Between the Owner and His Wife, Then Later Sell the Son an Interest Outside the Firm

The safest plan from a tax standpoint (but one which would not get any stepped-up basis and which would leave the son's capital account on the books materially less than his basis in, and cost of, his partnership interest) would probably be for the owner and his wife to form a partnership, contributing the business to that partnership in a tax-free exchange. Then the father, or mother, could sell the son an interest outside the firm. Since there would be no attempt to get a stepped-up basis and since there are no unrealized receivables or appreciated inventory items, the father should be assured of capital gains taxation on the sale.[1/] He would show a gain of the difference between the basis of his capital interest and the selling price. The son would have as a basis in his partnership interest the price he paid, but the books would reflect only the portion of the father's capital interest transferred to him.[2/] They would, however, probably still be under the family partnership rules since an interest is being purchased.

[1/] Code section 741 specifically provides that the gain or loss on the sale of a partnership interest is a capital gain or loss. The only hindrance would be if the sale to a son disallows capital gains treatment under section 707. As pointed out previously, that does not seem likely.

[2/] Of course, memorandum entries can always be made.

Conclusion

The difficulties and uncertainties relating to the partnership form are so great that the owner of Firm B has concluded that he cannot sell an interest to his son which would result in a partnership being formed.

Plans Using the Corporate Form

Firm B is not restricted to use of the partnership form of organization. A corporation could be formed. The next few paragraphs review three possibilities when that form is used.

Incorporation Would Have to Be Tax-Free

The discussion in Chapter II suggested that it is often advantageous for the transfer of assets to a corporation to be handled so as to be a taxable transfer. This allows the firm to get a stepped-up basis for depreciation and for gain and loss by paying a low capital gains tax at the time of the transfer. The transaction is made taxable by simply being careful to not meet all of the requirements for a non-taxable transfer. These requirements were analyzed in detail in Chapter III, starting on page 37.

The requirement which the firm usually tries not to meet when they want a transfer to be taxable is the "control" requirement. However, stock owned by a son is considered as owned by his father for purposes of determining control.[1/] So, any incorporation of Firm B will be tax-free.

Since there is no tax on incorporation, the alternatives are concerned with the stage of the proceedings at which the son should purchase his interest.

Father Incorporates Then Sells Some of His Stock

This is a simple solution and would accomplish what is wanted in letting the

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[1/] Code section 267(c)

son purchase an interest in the firm. The son could either purchase a block of the stock and pay for it over a period of time, or could purchase a few shares from time to time as he is able. The disadvantage of the latter procedure is that the stock would have to be valued each time a sale was made, unless some formula could be worked out in advance. Such a formula might set a price at the time the son first buys into the firm and provide that subsequent price would be that price plus or minus any changes in retained earnings to the date of purchase.

In order to demonstrate the tax effect of this type of sale, it is again assumed, as was done on page 53, that the business was worth $25,000 on December 31, 1957,[1/] and that the son was brought in at that date. If the business were worth $25,000 and there are liabilities of $9,700 as is shown in Table 4, incorporation could be accomplished by simply having the father transfer the business to the corporation in return for $15,300 per value of stock.[2/] Assuming $100 par value stock, the father would receive 153 shares of stock. His basis of each share, however, would be the basis of his proprietorship interest, which in this case is the same as his capital account balance of $7,000, divided by the 153 shares, or $46.

For each share sold, the father will report a gain of $54. This gain is, subject to adverse interpretation of Section 1239 discussed on pages 54-56,

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[1/]Refer to footnote 3 on page 52 for the reason for using this date instead of December 31, 1959.

[2/]A lesser value of stock could be used and the difference credited to Paid In Surplus, but in these small firms it is believed that issuance of par value stock equal to the value of the firm is simplest and least apt to be misunderstood. In the instance of Firm B, the price of the stock sold to the son can then be the par value.

The advantages of no par are insignificant to small, closely-held corporations. For a condensed but comprehensive appraisal of no par stock, see Burchett and Hicks, Corporation Finance, pages 81-85.

reduced by the 50 per cent capital gains deduction. The tax effect of sell shares would be:

Selling price of 50 shares at $100	$5,000
Basis of 50 shares at $46	2,300
Gain	$2,700
Long-term capital gains deduction	1,350
Portion of gain taxed at regular rates	$1,350
Tax at average rate in past of 22 per cent	$ 297

Since there is no attempt to get a stepped-up basis for depreciation, i believed that there is little question about the capital gains deduction appl either under strict interpretation of Section 1239 or by applying the intent the provision.

Son Purchases Shares from the Corporation for Cash

A simple method is for the son to purchase shares from the corporation fo cash. This method would let him acquire interest in the firm as he is able.

When this method is used, the cash paid by the son increases the capital c the corporation but the father receives no cash. If the Subchapter S tax-optio is elected, the father could obtain needed cash at no tax cost by having the corporation distribute all of its earnings as dividends. These earnings are nor taxable so long as they are not in excess of the undistributed taxable earnings since the date of the election. The son would participate in these non-taxable dividends, but he could reinvest them in the corporation by purchasing additional stock or just by loaning them back to the corporation.[1/]

Son Purchases New Equipment and Contributes It

The son could purchase equipment and contribute it in the same manner as was discussed for the partnership form. If the son can handle this type of transaction financially, it is easy and satisfactory. Even though the corporatio and the father had to guarantee contracts for purchase of equipment, the son could pay them off and so be purchasing the assets. This would add to the capita

1/ This must, of course, be a bona fide loan and should not be tied to the dividend distribution.

f the firm and would not require the father to sell any of his shares. Assuming hat the son's salary is set high enough so that he has funds with which to make he installment payments, no double tax is involved. However, if the son's salary annot be made high enough to do this and dividends are paid to give him funds, ouble taxation is involved. Even here, the special election under Subchapter S ay provide relief.

At the present level of earnings, there should be little question as to easonableness of salaries. The goal, therefore, would be for salaries to be set so that withdrawals of both father and son would be in the form of salaries. If the son purchases about one-third of the stock, or contributes enough assets to make his stock equal to that portion of the total, the chances are that an equitable formula can be worked out.

Plans Using a Tax-Option Corporation

The preceding section established that the corporate form seems to offer the best opportunity to bring the son of the owner into Firm B gradually at a price which gives the father a fair value for the work he and his wife have done in rebuilding the firm into a profitable business. Yet, the danger of paying a high price through higher federal income taxes, as reflected in Table 6 has prevented them from going ahead. The partnership-like tax option election permitted by Subchapter S may solve the problem.

Advantages of the Election

The computations summarized in Table 6 prove that the lowest tax would have been paid by Firm B and its owner in the proprietorship form actually used. The tax-option corporate form, however, would have given this same tax.[1/]

[1/] The computation of tax is not the same as in a partnership, even though the final tax is often the same. Examples are given later in this report where the tax is not the same as in the proprietorship or partnership form.

In all respects other than the computation of tax, the tax-option corporation is treated as a regular corporation. So, the corporate advantages in the formation of the firm could be obtained and, at the same time, the partnership advantage of lowest tax could be retained. Thus, formation of a corporation which chooses the partnership-like tax option under Subchapter S of the Internal Revenue Code appears to be the most satisfactory answer to Firm B's problem. The only immediate question is whether or not Firm B qualifies for the election.

Qualification for Election

The qualifications for the tax-option election are largely negative in character. Any corporation qualifies which "is not a member of an affiliated group" and which does not[1/]

(1) have more than 10 stockholders,

(2) have a shareholder (other than an estate) which is not an individual,

(3) have a non-resident alien stockholder, and

(4) have more than one class of stock

is qualified to choose the election. Firm B clearly meets all of the requirements so could choose the tax option.

However, the election is automatically terminated if more than 20 per cent of the corporation's gross receipts are from royalties, rents, dividends, interest, annuities and gains from sales or exchanges of securities, or if more than 80 per cent is from sources outside the United States. None of these possibilities concerns Firm B at the present time.

The principal provision which Firm B should concern itself with at the time

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[1/]Code section 1371.

of formation of a corporation under the tax-option election[1/] is the one which requires that there be only one kind of stock.[2/]

An especially important provision is that each stockholder must consent to the tax-option election in writing within 30 days before or after the start of the first year in which it is to be effective.[3/] Should some stock be sold to a third person, the election is automatically terminated unless that person submits a written consent to the election within 30 days.[4/]

Another pitfall which Firm B and every tax-option corporation must keep in mind is that qualification is automatically lost if any one of the requirements fails at any future time. Thus, if stock is sold so that there are eleven or more stockholders, the election is automatically terminated. Similarly, if an owner should die and have ten heirs or leave stock in trust, the election is automatically terminated. Provision should, therefore, be made when the corporation is established to prevent these things from happening through contract between the stockholders or other means which are appropriate under the particular law in the states the firm and the owners reside in.

Since the qualification can be terminated by so many happenings, the wise firm will pay all of its income to the owners yearly, either in the form of salary similar to that suggested in the optimum tax planning discussion for a regular

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[1/]A qualified small business corporation can make the election at the beginning of any year without permission. They can revoke the election at any time after the year in which they elect. However, once an election is revoked, or automatically terminated, a new election cannot be made for five years, unless the Commissioner of Internal Revenue gives written permission in advance. Sec. 1372(f).

[2/]The firm must be sure that loans or other debt instruments are not so similar to stock as to be construed essentially the same as stock. This possibility is explored in Chapter VI.

[3/]Reg. Sec. 1.1372-2(b).

[4/]Reg. Sec. 1.1372-3(b).

corporation, or through distributions of previously taxed income. Unless they do this, dividends from income on which the shareholders paid tax when the tax-option election was in effect become fully taxable after termination or revocation. This is no problem if the firm will just do what is suggested--distribute all income each year. If the firm needs the money, the stockholders can always recontribute it to the firm, either through additional stock purchases or through loans.[1/]

SUMMARY AND CONCLUSIONS

The analysis of taxes under alternative forms of organization demonstrated that a small firm with earnings of under $10,000 owned by one person is apt to pay considerably more income tax in the conventional corporate form than in the proprietorship or tax-option corporate form. However, if earnings can be withdrawn from a corporation as salaries, the tax will be nearly the same as in the proprietorship form but cannot be less.

The second analytical section was devoted to a search for a satisfactory way for the owner of Firm B to sell a portion of the firm to his son. Seven plans were investigated, four using the partnership form of organization and three using the corporate form. When the partnership form is used, it was found that there are worrisome tax uncertainties in addition to the managerial and control problems which are part of the partnership form. On the other hand, the corporate form is apt to cost significantly more tax year by year unless salaries can be set at the same level as net earnings. Furthermore, when the corporation is owned

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[1/] For further analysis of tax traps in the partnership-like election, see Green, "Subchapter S: To Elect or Not to Elect," 11 Syracuse Law Review (Fall, 1959) pages 81-87; "Dividends Must Be Planned Carefully for Subchapter S Corporations; Tax Trap Possible," 9 Journal of Taxation (Dec., 1958) page 360 (editorial comment); Alkire, "Study Every Distribution by an Electing Corporation," 10 Journal of Taxation (March, 1959) page 132. Many other articles point out possible tax traps and "boomerangs."

by five or less persons,[1] the law specifically denies the privilege of getting a stepped-up basis for the assets on formation of the corporation.

The problem demonstrated in terms of Firm B is the same problem which is faced by every owner of small business who wishes to sell a portion of his firm to a close relative. In the past the answer boiled down to weighing the tax factor of potentially continuous higher corporate tax against the organizational and control disadvantages of the partnership and the one-time uncertainty of tax at the time the partnership is organized. However, the partnership-like tax option election under Subchapter S provides a much more equitable possibility under today's law.

The Subchapter S tax-option election is not a cure-all, however. There are strict requirements which must be met before a firm can qualify for the election. Even after being qualified and choosing the election, the election is automatically terminated if the firm fails to meet any one of the qualifications at any time in the future.

It is highly desirable to distribute all income of a tax-option corporation each year so that there is no previously taxed income in the firm in the event of termination or revocation of the election. Those distributions can be in the form of dividends, which are tax-free if chargeable against income on which the stockholders have paid tax.

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[1]All members of a family are considered one person for purposes of this provision.

CHAPTER V--FIRM C

SALE OF A PORTION OF A PROPRIETORSHIP TO OUTSIDERS
Special Analysis: Sale vs. Contribution of Assets to a Partnership

This case study concerns a firm in which the organizational problem is centered around the method by which Charles Cabot sold his firm. He initially sold half of the firm, but agreed to sell the remaining half to the new owners at the same price whenever they were in a financial position to pay for it. Cabot became a partner in the new firm until all of his interest was sold to the new owners.

The special analysis section of this chapter studies the method of transferring the business to the new partnership comprised of Cabot and the two purchasers, Steve Collins and Tom Cook.[1/] While the plan followed by the firm is a fairly common one, especially when young businessmen with limited capital are purchasing an established business, there is no clear answer to the question of how to handle the transfer for tax purposes. This special analysis searches for acceptable answers and studies the tax effect of each.

HISTORY OF THE FIRM

General

Firm C is now organized as a partnership. Collins and Cook purchased half of the business on July 1, 1953, and half on July 1, 1954. During the year July 1, 1953, to June 30, 1954, Cabot was a partner in the business with a 50 per cent interest in assets and in profits after partners' salaries. Cabot drew a salary for only the time he spent working in the business.

[1/]As was noted in the introductory chapter, these names are hypothetical. Each owner is given a name corresponding to the letter designation of the firm. The original owners are given names whose second letter is in the first part of the alphabet (C<u>a</u>bot). The new owners are given names with the second letter in the last half of the alphabet (C<u>o</u>llins and C<u>o</u>ok).

TABLE 7
FIRM C
EARNINGS AND TAXES PAID

	Fiscal Year Ended						
	6-30-54	6-30-55	6-30-56	6-30-57	6-30-58	6-30-59	6-30-60
Partnership Erngs.:							
Sales	$144,300	$150,200	$160,400	$177,400	$206,600	$262,300	$228,100
Cost of sales[a]	109,700	128,100	133,900	148,200	171,600	216,100	194,400
Gross profit	$ 34,600	$ 22,100	$ 26,500	$ 29,200	$ 35,000	$ 46,200	$ 33,700
Operating exp.[a]	13,300	16,100	15,000	17,700	18,500	28,600	27,500
Net profit	$ 21,300	$ 6,000	$ 11,500	$ 11,500	$ 16,500	$ 17,600	$ 6,200
Tax Paid by Partners:[b][c]							
Collins	$ 1,223	$ 830	$ 1,356	$ 1,362	$ 1,966	$ 2,042	$ 929
Cook	1,355	969	1,488	1,493	2,122	2,198	797
Cabot	2,180						
Total tax paid	$ 4,758	$ 1,799	$ 2,844	$ 2,855	$ 4,088	$ 4,240	$ 1,726

[a] Includes partners' salaries of about $8,000 each year.

[b] Ignores small amounts of other income (less than $250 annually)

[c] Uses standard deduction throughout even though itemized deductions were used by the owners in some years. This gives a more uniform base for comparison.

Financial History

The profits earned by the business and the taxes paid are summarized in Table 7. The earnings figures are rounded to the nearest hundred dollars for ease of reading.

Note that the first year of operations, when Cabot held a half interest, was an unusually profitable year. This was due in large measure to a drop in the cost of raw materials after firm prices had been set on the finished product. The drop in sales in the year ended June 30, 1960, was caused by a drop in sales quantities which, in turn, was due to a drop in agricultural prices.

The partners have followed a policy of drawing most of each year's profits out of the business unless cash had to be retained to purchase equipment or carry inventory. Each partner has drawn equal amounts, although there have been temporary differences from time to time. They have drawn a small regular salary which is no larger than the salary paid to their key employees. The business is a seasonal one

so they have used bank credit to furnish working capital during the peak months.

The portion of profits which was withdrawn each year can be seen by comparing the annual withdrawals reflected in Table 8 with the profits tabulated in Table 7.

TABLE 8
FIRM C
PARTNERS' WITHDRAWALS

Fiscal Year Ended June 30	Total	Collins	Cook	Cabot
1954	$15,100	$ 4,600	$ 4,600	$ 5,900
1955	6,200	3,100	3,100	
1956	11,000	5,500	5,500	
1957	10,000	5,000	5,000	
1958	12,000	6,000	6,000	
1959[a]	-0-	-0-	-0-	
1960[a]	16,200	8,100	8,100	
Total	$70,500	$32,300	$32,300	$ 5,900

[a]Withdrawals are ordinarily made before the end of the fiscal year, but none were made in June, 1959. Instead, the portion of the 1959 profit which was to be distributed was withdrawn in July, 1959. The 1960 disbursement was made in June, 19

The way in which the profits which were not withdrawn were used in the business can be most easily visualized by comparing the balance sheets of the firm when they

TABLE 9
FIRM C
CONDENSED COMPARATIVE BALANCE SHEETS

	7-1-53		6-30-54		6-30-60	
Current Assets:						
Cash			$12,100		$ 700	
Receivables			5,500		12,900	
Inventories	$5,400		5,200		8,600	
Prepaid expenses		$ 5,400	100	$22,900	500	$22,700
Plant & Equipment:						
Cost	$9,000		$ 9,600		$26,800	
Accumulated dep.	-0-	9,000	900	8,700	13,300	13,500
Total assets		$14,400		$31,600		$36,200
Current Liabilities:				$ 900		$ 4,700
Long-term portion of contr.						500
Equity:						
Collins	$3,600		$ 8,900		$15,500	
Cook	3,600		8,900		15,500	
Cabot	7,200	14,400	12,900	30,700		31,000
Total liab. & equity		$14,400		$31,600		$36,200

were organized with the present balance sheet. Table 9 provides this comparison.[1/]

TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

Taxes which would have been paid under alternative forms of organization are summarized and compared with taxes actually paid in Table 10. This table contains the same type of information as the corresponding table in the two preceding chapters, so needs no detailed explanation here.

Total sales are repeated from Table 10 in order to provide a better basis of comparison without having to refer back and forth between tables.

Since there were no unusual transactions such as operating losses, capital gains, or withdrawals in excess of capital, the tax in the tax-option corporate form is the same as in the partnership form.

Since the net income, deductions, and all other data were known when the computations of tax under optimum planning in the conventional corporate form were known, it was possible to derive a formula (set forth in footnote "c" to Table 10) which would bring the tax to within a few dollars of the tax in the partnership and tax-option forms. This would be difficult to do in practice where the formula has to be set in advance. The tabulation shows, however, that under ideal circumstances the tax in the corporate form can be nearly, but not quite, equalized with the tax in the partnership form.

The tax is nearly double the tax in the partnership form when the corporate form is assumed, but withdrawals are treated as dividends (the "No Planning" column in Table 10). No effort was made to use assumptions which would result in a high tax. Instead, the computation reflects the actual transactions exactly as

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[1/] Both beginning and ending balance sheets for 1954 are included in order to provide information which is important in studies discussed later in this chapter.

TABLE 10
FIRM C
COMPARISON OF TAXES UNDER ALTERNATIVE FORMS OF ORGANIZATION

Fiscal Year Ended June 30	Actual Transactions			Tax in Alternative Forms			
						Conventional Corp.	
	Total Sales[a]	Total Income[a]	Total Tax Paid [b]	Partnership	Tax-Option Corp.	Optimum Planning[c]	No Planning[d]
1954	$ 144,300	$ 30,100	$ 4,758	$ 4,758	$ 4,758	$ 5,121	$11,055
1955	150,200	14,500	1,799	1,799	1,799	2,480	3,305
1956	160,400	19,800	2,844	2,844	2,844	2,592	5,671
1957	177,400	19,900	2,855	2,855	2,855	2,578	5,457
1958	206,600	25,000	4,088	4,088	4,088	2,992	7,297
1959	262,300	25,600	4,240	4,240	4,240	4,123	5,910
1960	228,100	14,500	1,726	1,726	1,726	2,480	5,082
	$1,329,300	$149,400	$22,310	$22,310	$22,310	$22,366	$43,777

[a]Rounded to the nearest hundred dollars. Includes owners salaries.

[b]Individual taxes are for the calendar year in which the fiscal year Firm C ended. However, salary income is the amount for the firm's fiscal year, so tax is the same as if the owners' taxable year coincided with the June 30 fiscal year of the firm.

[c]This computation assumes a salary of $9,000 to each partner plus a bonus of 20% of the corporate profit before taxes. This formula gives a net operating loss in 1955 and 1960. Effect is then given to carrybacks and carryovers. The net effect is that only $3,398.04 of corporate income is taxed.

Detailed computations are on file at the University of Nebraska. Net operating loss carryovers and carrybacks are discussed in Chapters X and XIII.

[d]This computation assumes that salaries are the same as were paid in the partnership but that remaining withdrawals were taken as dividends.

they were handled in the partnership form. The only difference (other than the corporate tax itself) is that the withdrawals in the partnership form were not taxed to the partners, but these become dividends in the corporate form and double taxation results.[1] Clearly, therefore, tax planning in the form of taking withdrawals in the form of salary, bonus, interest, or other deductible form rather than as dividends is essential if a firm such as Firm C chooses the conventional corporate form and is not to pay far more than its just tax.

[1]Double taxation of dividends is discussed in Chapter II on page 14.

SPECIAL FACTORS ILLUSTRATED BY THIS CASE

Nature of Problem Studied

The method by which Cabot sold the business is believed to be quite common, so it is of value to investigate the tax status of the transfer of the business to the partnership in which Cabot had a half interest. At least three possibilities suggest themselves: (1) Cabot could sell the entire business to the partnership, (2) Cabot could sell half of the assets to the new partners and half to the partnership, or (3) Cabot could sell half of the assets to the new partners and contribute half of the assets to the partnership. The analysis in the ensuing pages will attempt to discover which of these three possibilities is the proper one and review the effect of each of the three interpretations on the amount of Federal income taxes which would have to be paid by the firm.

Some Fundamental Concepts Which Bear on the Issue

The answer to which of the three possibilities outlined in the preceding section is the proper, or best, view lies in a combination of several basic concepts which pertain to the taxation of partnerships. Some of the most important matters are mentioned in the next few paragraphs and are annotated to sources which explore them thoroughly.

The "Aggregate" and the "Entity" Theories

The Internal Revenue Code contains a compromise between the aggregate and the entity theories of the partnership.[1] It seems to be based on the criteria of "desirable result" and applies whichever theory will produce that result. It follows the aggregate approach in that a partnership pays no tax. On the other

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[1] For discussion of these approaches and the way by which they found their way into our law, see Willis, Handbook of Partnership Taxation starting on page 11, and Jome, Corporation Finance, footnote on page 22.

hand, the general treatment of partner-partnership transactions is based on the recognition of the partnership as a separate entity. This is the basis for finding, later in this chapter, that a partner can sell assets to a partnership of which he is a member. Even here, however, the entity approach is tempered by a series of elections which are designed to enable the partners to achieve equity between themselves through an "aggregate" treatment of tax consequences.[1/]

Many Partnership Provisions Were New in the 1954 Code

Prior to enactment of the 1954 Code, there was little in the tax law dealing with partnerships. Accountants commonly tried to follow what they considered to be good accounting practice. This worked fine so long as there were no conflicts which found their way into the courts. When that happened, the court had little to base a decision on and many conflicts arose.

Since so much of the partnership section of the 1954 Code is new in the law, much of it still has not been tested in the courts. The provisions relating to the handling of the sale of half of Firm C is clearly one of those areas.

Statutory Provisions for Choice Between Treatment as a Sale and Treatment as a Capital Contribution to the Partnership

Code Provisions

Section 707(a) authorizes handling a transfer of assets to a partnership as a sale.[2/] There are as yet few court decisions which can be referred to for examples of the type of transaction covered by Section 707(a), but the Congressional Committee reports which were issued when the provision was reported out of committee indicate clearly that the transfer of assets by a proprietor to a newly formed

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[1/] For an expanded treatment, see Rabkin and Johnson, ¶ 16.01.

[2/] Other parts of Section 707 set forth three modifications: (1) the disallowance of losses where the partner owns more than 50 per cent interest, (2) the disallowance of capital gain benefits on a sale where the partner controls more than an 80 per cent interest, and (3) guaranteed payments.

partnership is intended to be included as a transaction which can be treated as a sale.[1]

On the other hand, another section of the Code, Section 721, provides for a tax-free contribution of property to a partnership. A transfer of assets to a partnership can, therefore, be either a contribution or a sale. Both are recognized in the Code.

Distinction Between a Contribution and a Sale

The regulations attempt to tie Code Sections 707 and 721 together.[2] They indicate clearly that the Internal Revenue Service intends to allow the partners considerable discretion in choosing whether to handle a transfer of assets to a partnership as a sale or as a contribution.[3] This is in accord with the intent of Congress, as expressed through their Committee Report,[4] that partners should have the same general choices as are available to corporate stockholders in this area, and that the tax treatment should be similar.

Importance of Making Every Aspect of the Transfer Agree with the Alternative Desired

The Code does not, as careful reading of the sections cited in the preceding paragraphs, provide for an election as such. Rather, the partners have to report the transfer in accordance with the method actually used in the transfer of assets to the partnership.

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[1] Senate Report No. 1622 (1954) 386, 83rd Congress, 2nd Session.

[2] Section 1.721-1(a)

[3] For development of the idea that the partners have considerable discretion in this area, see ¶ 16.07 of Rabkin and Johnson; Chapter 7 of Willis, *Handbook of Partnership Taxation*; ¶ 3944 of Commerce Clearing House's *Standard Federal Tax Reports*; ¶ 7015.15 of Prentice-Hall's *Tax Ideas* service; and corresponding sections of other services.

[4] Senate Report No. 1622 (1954) 386, 83rd Congress, 2nd Session. Also reproduced at ¶3942.10 of 1955 *Standard Federal Tax Reporter* by Commerce Clearing House, and comparable sections of other services.

The determining factor is the intent of the parties.[1] The form of the transaction is merely evidence of that intent. The regulations themselves[2] emphasize this when they warn that "substance of the transaction will govern over the form."[3]

It is essential, therefore, that the partners decide well in advance of the transfer whether they want the transfer to be a sale or to be a contribution, then make every detail point toward the result they desire.

Tax Effect

Since the statute allows the transfer of assets to a partnership to be either a sale or a contribution in return for a capital interest, it is important to know the tax effect of each method. The next few paragraphs summarize that effect.

Transferor

When assets are contributed to a partnership, the transferor has neither gain nor loss[4] on the transfer. This is true whether the transfer is to a new partnership or to an existing partnership.[5]

When assets are sold to a partnership, the transferor must recognize gain or loss just as he would if the sale were to anyone else.[6] This means that he will probably receive capital gains treatment if the sale is for more than his cost less accumulated depreciation, but will be allowed full deduction if the sale results

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1/ See Rabkin and Johnson, ¶ 16.07 for a concise statement of the law and rulings behind this observation.

2/ Section 1.721-1(a)

3/ This concept is further emphasized in the regulations on the distribution of property to a partner, Section 1.721-1(c)(3).

4/ Code section 721.

5/ Code section 721.

6/ See the discussion on page 74 for the statutory provision and for exceptions to this general statement.

in a loss.[1/]

The Partnership

The tax effect of the choice between a sale and a contribution of assets is more complicated on the side of the partnership than it is to the transferor. The complications arise in the determination of the basis for gain or loss and for depreciation of the assets in the hands of the partnership, and in the effect on the income of each partner.

Basis of property to partnership under each method.--When assets are sold to a partnership by one of the partners, the basis is simply the cost to the partnership just as if the purchase had been from anyone else.[2/] When assets are contributed to a partnership in return for a capital interest, the basis is the adjusted basis of the property to the contributing partner.[3/] [4/] Thus, if Cabot is considered to have contributed half of the assets of the firm to the new partnership, the basis of that half of the assets will be the cost to Cabot less the depreciation he had deducted.[5/] This might bear no relationship to the price the new owners are paying. The effect of this possibility is discussed in the next few paragraphs.

Effect on partnership profits.--The basis of property to the partnership may have a material effect on the division of profits between the partners or even upon whether or not the partnership form of legal organization is an acceptable form to

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1/ See the general summary in Chapter II, pages 16 and 17.

2/ Code section 707 provides that the treatment is the same as if the purchase was from one who is not a partner. Section 1012 provides that the basis of property is cost unless otherwise specifically provided elsewhere in the Code.

3/ Code section 723.

4/ This has been the statutory rule since the 1928 Code. (Crompton, "Partner-Partnership Transactions," Proceedings of New York University Fifteenth Annual Institute on Federal Taxation.)

5/ There is no question about the other half. He must have sold that half either to the partners or to the partnership.

the partners. It makes little difference to Firm C because the selling price of the assets was $9,000 and this just happened to be close to the adjusted basis to Cabot. Suppose, on the other hand, that Cabot's adjusted basis had been reduced to $1,000 by accumulated depreciation. If he contributed half of the assets to the partnership, that half of the assets would have a basis in the partnership of $500, while the other half would have a basis of $4,500--the price Collins and Cook paid for them.[1/] This basis is used in computing depreciation and also in computing a gain or loss on a subsequent sale of the assets.

In order to demonstrate the effect of the basis provisions regarding a contribution, suppose that shortly after the partnership had been formed the firm sold an asset which had been valued at $1,000 in the formation of the firm for that same $1,000 amount. From an economic point of view, there was neither gain nor loss. However, if the transfer is viewed as a contribution and Cabot is assumed to have had an adjusted basis of $1,000 in all of the assets, and of $100 for this asset there is a taxable gain computed as follows:

	Half Contrib. By Cabot	Half Contrib. By Collins and Cook	Total
Selling price	$500	$500	$1,000
Basis	50	500	550
Taxable profit	$450	-0-	$ 450

Collins and Cook would probably not be willing to pay tax on their share of the $450 "profit" when in reality there is no profit. The same situation would exist regarding depreciation. The total basis for depreciation of the assets would be $5,000 ($4,500 on the half purchased or contributed by Collins and Cook, and $500 on the half contributed by Cabot), but Collins and Cook would likely believe that they should be allowed depreciation based on the price of $9,000.

1/ This will be true whether the transaction is interpreted as being a sale to Collins and Cook and a subsequent contribution by them of the assets so purchased, or if it is interpreted as a sale of this half to the partnership by Cabot.

If the transfer is treated as a sale by Cabot to the partnership, Cabot would pay tax on the profit on the sale itself and the partnership would have a basis of $9,000 in the assets rather than the split basis. Collins and Cook would then get the depreciation they are entitled to, and there would be no gain or loss on the sale of the hypothetical $1,000 asset used in the demonstration in the preceding paragraphs. This seems closer to the intent of the parties.

<u>Relief measure in the 1954 Code</u>.--The Code recognizes the inequity of the type of situation demonstrated on the preceding page, and attempts to relieve it by permitting the partners to agree to allocate all of the $450 profit to Cabot and to agree that Collins and Cook are entitled to most of the depreciation.[1] This measure can be illustrated in terms of the hypothetical asset used in the demonstration on page 78. Assuming that the depreciation rate on this asset is 10 per cent and that the asset had been held instead of being sold, the depreciation could be allocated as follows:[2]

Collins--$\frac{1}{4}$ of 10% of $1,000	$25
Cook--$\frac{1}{4}$ of 10% of $1,000	25
Cabot--$\frac{1}{2}$ of 10% of $100	5
Total allowable--10% of $550	$55

It is essential that, if an allocation such as the one just illustrated is to be used, the exact terms be clearly set forth in the partnership agreement and that it be used in the actual division of profits as well as for division of taxable income. If the partnership agreement says nothing, the depreciation and the gain would have to be divided in accordance with the division of ordinary

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[1]Code section 704(c)(2)

[2]For further examples of how this provision is applied, see <u>Partnership Income Tax Guide</u>, issued as Standard Federal Tax Reports, Volume XLIV, Number 17, Part 1, April 3, 1957, by Commerce Clearing House, Inc., pages 42 and 43.

profits.[1/] That is, the gain on the hypothetical asset sale would be divided as follows (since Cabot had a 50 per cent interest in profits and Collins and Cook each had a 25 per cent interest in profits):

Collins--¼	$112.50
Cook--¼	112.50
Cabot--½	225.00
Total taxable gain	$450.00

And depreciation would be divided (assuming the asset held instead of being sold):

Collins--¼	$13.75
Cook--¼	13.75
Cabot--½	27.50
Total allowable--10% of $550	$55.00

Specific Application to Formation of Firm C

The foregoing analysis pointed out that the Code now allows partners to choose to treat the transfer of assets of an existing business to their partnership either as a sale to the partnership or as a non-taxable contribution to the partnership in return for a capital interest. These are not, however, elections which are made when the tax return is filed. Instead, they are chosen by the way in which the transaction is originally handled.

Alternatives Available to Firm C

As was pointed out on page 73, three major alternatives were available to

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1/ Code section 704(c)(1) makes this explicit. The House version of the 1954 Code provided that all gains and losses had to be divided as demonstrated above, but considerable objections were raised in the Senate hearings, so the Senate added section 704(c)(2) to allow partners to share depreciation, depletion, and gains and losses on sales of property so as to take into account the variation between the basis of the property in the partnership and its fair market value at the time of contribution. This is the provision demonstrated in this section.

The regulations (Section 1.704-1(c)(2)) are more liberal than the Code and committee reports in that the allocation for "all contributed property or to specific items." The Code and committee reports do not mention allocation for only part of the items.

Cabot when he sold half of his business to Collins and Cook. One of these has two variations. All should have been investigated carefully before any action was taken in forming the partnership or transferring the assets, then every aspect of the transaction made to conform to the alternative chosen.[1/]

Alternatives Involving Sale.--The first two alternatives suggested on page 73 involve a sale. In Alternative 1, the partnership is formed first, then the business purchased from Cabot. In Alternative 2, Cabot sells half of the assets to Collins and Cook who, in turn, transfer them to the partnership. Cabot sells the other half to the partnership. In both of these alternatives, Cabot would have to pay tax on the entire gain at the time of the formation of the partnership,[2/] and the basis of the assets for depreciation and for computation of gain or loss is the purchase price of $9,000.

Alternatives Involving Contribution.--The method of handling the transaction is the same under the two methods which involve contribution of the business to the partnership, so both are treated as phases of the same alternative. The important distinction, so far as making the transfer is concerned, lies in the fact that alternative 3(b) must be specifically provided for in the partnership agreement. If such provision is not made, alternative 3(a) must be followed.

Both phases of Alternative 3 require that Cabot sell a half interest in the business to Collins and Cook before the partnership is formed. Each of them later contributes his interest to the partnership. This means that Cabot has sold half of his business and has contributed half of it to the partnership. He pays tax on only the gain on the half which was sold at the time the partnership was formed.

[1/]Firm C was formed in 1953, a full year before the 1954 Code was enacted. It is interesting to note, however, that the alternatives considered were essentially the same as those now specifically permitted under the 1954 Code, in spite of the fact that there was almost nothing in the law at that time to serve as a guide.

[2/]Note that capital gain treatment would be denied if the transferor and his family owned over 80% of the partnership, and that a loss would be disallowed if they owned over 50% of the partnership.

He need not pay tax on the gain on the sale of the other half until the year in which Collins and Cook purchased his interest in the partnership. This spreads the gain into two years and could result in it being taxed in lower brackets.

In both phases of Alternative 3 the assets will have two different bases for gain and loss and for depreciation: (1) half of each asset will be valued at the price paid by the purchasing partners and (2) half of each asset will be valued at the adjusted basis to Cabot. This was illustrated on page 78.

The distinction between the two phases of Alternative 3 is simply whether or not the relief measure described on pages 79 and 80 is provided for in the partnership agreement. Under Alternative 3(a) nothing is said in the partnership agreement about the relief measure. Each partner pays tax on the profit computed according to his regular percentage of profits computed as though the basis that is carried over from the contributing partners were a purchase cost. Thus, the basis of the assets of Firm C would be $4,500 for the half purchased by Collins and Cook and a carryover of Cabot's adjusted basis for the other half. The division of profits in this situation is illustrated on page 78.

This division of profits and of depreciation may lead to results which are quite contrary to the intent of the partners, so extreme care should be taken to be sure that each partner understands the effect of this provision under all of the possible profit and loss situations which may develop in the future.

Alternative 3(b) allows the partners to avail themselves of the Section 704(c)(2) relief measure analyzed on page 79. If the partnership agreement specifically provides for it, Cabot would be allocated gains and losses attributable to the difference between the tax basis of the property and the fair market value of the property at the date of contribution, and Collins and Cook would be allocated most of the depreciation up to the amount which is attributable to their

share on the fair market value of the property at the date of contribution. An example is given on page 80. This method can become highly complex, but can also be more equitable than Alternative 3(a).

Method Chosen

In the instance of Firm C, the adjusted basis to Cabot was close enough to the selling price to the partnership that there was little difference in the tax effect under any method. Alternative 1 was followed. The partnership existed for only one year until the new partners were able to purchase the remainder of the firm, so the tax effect of depreciation allowances and gain and loss on sale of individual assets was not significant.

Advice to Other Firms

Most firms are not so lucky as Firm C in having the basis of the seller close to the purchase price, so the choice of method becomes important to them. They will often have to weigh the advantage of getting a stepped-up basis for the assets in the partnership and of having a simple depreciation and asset schedule, against the cost to the transferor partner of having to pay tax on the entire sale at the time the firm is formed. If the transferor can save tax by treating the formation as a contribution, he might be willing to make a concession on price or on the proportion of profits he will want in the new firm. The important thing is that all alternatives be carefully weighed in advance and that all detail be directed toward the alternative desired.

Applicability to the Corporate Form

If the corporate form had been chosen, the alternatives are nearly the same. The 1954 Code deliberately followed the corporate rules in setting up these alternatives for partnerships. The arguments for and against making the transaction a taxable contribution or a non-taxable contribution to a corporation are summarized

in Chapter II,[1] and the specific requirements for a non-taxable contribution of assets to a corporation were analyzed in detail in Chapter III. The essential thing, as in the case of the partnership form, is that the alternatives be investigated thoroughly ahead of time and the transaction then be carried out, both actually and in form, in the manner which will achieve the results wanted.

SUMMARY AND CONCLUSIONS

The Federal income tax which would have been paid by Firm C under alternative forms of legal organization were compared in the first analytical section. Both the partnership and the tax-option corporate forms gave the same tax. The total tax in the corporate form with no tax planning would have been nearly $21,500 higher than the tax in the partnership and tax-option forms. However, it was possible to reduce the tax difference to only $56 by devising a tax planning formula which assumed that profits were withdrawn in the form of salaries and bonus rather than as dividends. This tax planning is a calculated risk in that there is always a chance that the Internal Revenue Service would contend that the salaries were excessive. It is believed, however, that the salaries and bonuses used in the computations for Firm C could be substantiated as reasonable in view of the training, ability, and responsibility assumed by the owners.

The special factors studied reveal the principles involved in the transfer of assets to a partnership by a partner. The study was made specific by examining the alternatives which Firm C could have followed. It was found that there are two basic alternatives available to partners generally--(1) to treat the transfer as a sale, and (2) to treat the transfer as a capital contribution. These basic alternatives were found to be further divisible into variations of each. The sale can be handled either as a sale to the partnership of which the transferor is a member, or,

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[1] See the discussion entitled "Should Incorporation Be Tax-Free?" on page 20 in Chapter II. The same effect pertains here.

when new partners are being admitted to a firm formerly operated as a proprietorship, to the new partners who then transfer the assets to the firm. The tax effect of these two alternatives is similar.

The contribution alternative has two variations so far as tax influence is concerned. The variation concerns the method of dividing profits on the sale of assets and the depreciation on assets between the partners. When nothing is said in the partnership agreement the division of these items is the same as for ordinary income. However, under a relief provision of the Code, the partnership agreement can provide for a special division of these items. This latter variation can become highly complex, but can, at the same time, help achieve equity between the partners. The partnership agreement must provide for this latter variation or it cannot be used.

The main point established by this analysis is that the choice between treating a transfer of assets to a partnership as a contribution or treating the transfer as a sale is made when the transaction occurs, not when the tax return is filed. Once the transfer is made, the tax treatment is set. It is most important, therefore, that everyone having anything to do with the formation of a partnership in which the partners are to transfer any property other than cash to the firm be aware of the alternatives and study each carefully before the transaction is contracted. They should compute the tax result of all of the eventualities and be sure that the partners understand the implications of each possibility. Then, once a decision is made, all details should be directed toward evidencing the alternative chosen.

CHAPTER VI--FIRM D

CHANGES IN FORM OF ORGANIZATION SEVERAL TIMES
Special Analyses:
Sale vs. Contribution of Assets to a Corporation
Advances From Stockholders
Use of Two Corporations

Firm D changed its form of legal organization several times before settling on the present tax-option corporate form. This chapter is devoted to a study of the tax effect of those changes. Three special factors which Firm D encountered have wide applicability to other businessmen so are examined in the special problems section. These factors are: (1) Tax saving which could have resulted from selling assets to the corporation instead of contributing them in return for capital stock; (2) Advances from stockholders; and (3) The effect of forming two corporations rather than one.

HISTORY OF THE FIRM

Proprietorship

Formation of Firm D fulfilled a lifelong ambition of Arthur Day. He had started work in a similar plant as a delivery boy while in school and had worked up to production superintendent. Soon after he decided to resign and start a small plant of his own in a nearby town, he started purchasing used machinery and equipment.

Day's search for this machinery led him to contact Sidney Dunn. Dunn was a salesman for a large equipment manufacturing firm and had called on Day regularly for about four years.

Partnership

Day soon realized that he did not have enough capital and that he lacked training and experience in management. Since Dunn had savings which he was willing

to invest and since he had some management background, Day invited him to join the new venture.

Dunn accepted the offer and they formed a partnership. Each contributed $4,500 cash. They agreed that Day was to manage the firm and Dunn was to retain his sales position. Day was to receive a salary of $100 a week for operating the business, and remaining profits or losses were to be divided equally. Dunn was to act as general consultant and adviser, but spend no time on actual operations.

Day and Dunn were able to equip the plant with the essential machinery for a little less than $8,000. Had Day attempted to go ahead as a proprietorship, as he originally planned, he would have had to borrow and would probably not have been able to obtain the selection of used equipment which was available to Dunn through his sales position.

Two partnerships

In July, 1956, Day and Dunn purchased a similar business in an adjoining town. Dunn resigned his sales position and became manager of this second plant (hereinafter designated "Plant B"). They operated this business as a separate partnership for two months.

Corporation with two plants

At the end of two months, a corporation was formed. Each partnership business was contributed to the corporation in a non-taxable exchange for capital stock of the corporation. Each plant continued to operate under its trade name. Day continued to manage the original plant and Dunn continued to manage the new plant just as they had in the partnerships.

The corporation was authorized to issue 250 shares of $100 par common stock,

and each former partnership received 125 shares of the stock.[1/]

The equipment of Plant A, which had now been operated for three years, had been repaired and rebuilt so that it was worth considerably more than when it was purchased. Most of the repairing had been done evenings and week-ends by the owners, so no labor cost was incurred. Many of the repair parts had been charged to expense.[2/]

The machinery was written up to a realistic value and the remainder of the difference between the book value of the firm and the $25,000 valuation was entered as goodwill.[3/]

[1/] Many firms obtain authorization for more stock than they plan to issue immediately so that they will not have to amend the charter if they want to issue a few additional shares. However, many states levy a tax on the authorized rather than on the issued stock. While these state taxes are usually nominal, an unnecessary tax burden is incurred if authorized stock is substantially in excess of the amount which is to be issued. It is easier for a small, closely-held corporation to amend its charter than it is for the publicly-held corporation which might have difficulty in getting enough stockholders to consent to a change in the charter.

For additional discussion of this point, see Guthman and Dougall, Corporate Financial Policy, third edition, p. 54, and Kimball, Corporation Finances--Principles and Practice, pp. 31-32.

[2/] Not all repairs to newly acquired, second-hand machinery are deductible. When extensive "repairing" is performed when or shortly after a machine (or other asset) is acquired, the cost of those "repairs" may be part of the cost of acquiring a usable machine just as freight is part of the cost. Many costs which are incurred during the first few weeks a second-hand machine is operated must be considered part of the cost of the machine, while those same repairs to a machine which had already been used by the business for several years are deductible.

The law and regulations give little specific guidance other than a general rule (Reg. P 1.162-4). The businessman must use common sense and be guided by a sense of fairness. Some guidance can be found in court cases. Many of these cases deal with buildings, but the same principles apply to machinery and other assets. A comprehensive study with an analysis of cases to 1958 is contained in Wriggins and Byron, Repairs vs. Capital Expenditures. All of the loose leaf tax services and encyclopedias discuss the principle involved and cite leading and current cases.

[3/] The basis of the assets for tax purposes remains the same as in the predecessor partnerships whenever the incorporation is tax-free. The "value" of the assets for tax purposes will, therefore, be different than on the general records and financial statements of the firm. There is nothing wrong with this and the Treasury Department recognizes it as necessary. The corporate tax return even has a schedule (M) which reconciles the difference to the extent it affects retained earnings.

In order to summarize the cost of each plant and the adjustments made to bring the books up to the $25,000 valuation, the balance sheets of each partnership just prior to incorporation and the balance sheet of the corporation just after incorporation are presented in Table 11. The relationships reflected in this table have an important bearing on the problems discussed later in this chapter.

TABLE 11
FIRM D
BALANCE SHEETS AT DATE OF INCORPORATION

	Partnership A	Partnership B	Write up to Corp. Value	Beg. Balance of Corp.
Current Assets:				
Cash	$ 600	$ 900		$ 1,500
Receivables (net)	3,300	3,400		6,700
Inventories	1,800	3,500		5,300
Prepaid expenses		100		100
Total current assets	$ 5,700	$ 7,900		$13,600
Property and Equipment--net after deducting accumulated depreciation	10,200	14,100	$ 3,000	27,300
Goodwill		3,000	4,700	7,700
Other Assets	100	100		200
Total assets	$16,000	$25,100	$ 7,700	$48,800
Current Liabilities:				
Accounts payable	$ 1,500	$ 1,600		$ 3,100
Payroll taxes withheld & accrued	100	300		400
Equipment purchase contract payable	1,300			1,300
Total current liabilities	$ 2,900	$ 1,900		$ 4,800
Deferred Credits		3,400		3,400
Long-term Debt:				
Equipment purchase contracts	2,000			2,000
Mortgage		13,600		13,600
Total liabilities	$ 4,900	$18,900		$23,800
Capital	11,100	6,200	7,700	25,000
Total liabilities and capital	$16,000	$25,100	$ 7,700	$48,800

Corporation with one plant

In 1959 two major changes took place. Both of these changes resulted from conditions which are common in small business.

Difficulties encountered.--As can be seen in Table 12 in the next section, sales increased nearly $25,000 each year, but profits did not increase correspondingly. Both Day and Dunn were working 70 hours or more a week. They concluded that if the businesses were to continue to grow, they had to find more time for such management functions as planning and coordination, as well as direction, control, and organization. To do so required that they be released from many of their operational duties in production.

Operations consolidated.--In order to achieve these things, they decided to consolidate operations at Plant B. Plant A was sold at the appraised value of the equipment. Since the towns were located in the same metropolitan area, Dunn did not have to move and had no serious problem in driving to work at Plant B.

Day purchased Dunn's interest.--The second major change which occurred in 1959 resulted from the consolidation of operations. While Day and Dunn planned to divide duties, each had been in full charge of his plant long enough that they found this division difficult to achieve. Soon they began to have disagreements. Finally, Day purchased Dunn's stock.

Tax-option corporation

Firm D elected the partnership-like taxation allowed by Subchapter S of the Internal Revenue Code as soon as it was available in 1958.

Earnings and Taxes Paid

The earnings of Plant A during the first two and one-half years were just about equal to the salary paid to Day for managing the business. No other withdrawals were made. The capital accounts of each partner totaled $4,246.04 on January 1, 1956. Since each had invested $4,500 and no withdrawals had been made, this means that each was charged with a total net loss of $253.96 during this two and one-half year period. However, this loss figure does not mean that the firm

TABLE 12
FIRM D
EARNINGS AND TAXES PAID

	Partnerships		Conventional Corporation		Tax Option Corporation
	Plant A	Plant B			
	1/1/56 to 9/30/57	7/1/56 to 9/30/57	10/1/56 to 7/31/57	8/1/57 to 7/31/58	8/1/58 to 7/31/59
Income:					
Sales	$19,100	$7,100	$66,700	$91,100	$115,200
Processing costs	14,000	7,200	60,800	84,700	108,600
Gross profit (loss)	$ 5,100	$ (100)	$ 5,900	$ 6,400	$ 6,600
Operating and other costs	2,300	500	5,300	6,000	5,800
Net operating profit (loss)	$ 2,800	$ (600)	$ 600	$ 400	$ 800
Gain (loss) on sale of assets				(200)	2,700
Net other income (expense)			(700)	(1,000)	(1,400)
Net profit (loss)	$ 2,800	$ (600)	$ (100)	$ (800)	$ 2,100
Non-deductible expenses			100	700	
Taxable profit (loss)	$ 2,800	$ (600)	-0-	$ (100)	$ 2,100
Taxes Paid:					
By corporation			-0-	-0-	
	Calendar Year				
By owners[a]	1956	1957	1958	1959	Total
Day	$ 700	$ 500	$ 600	$ 800	$ 2,600
Dunn	-0-	900	1,300	1,300	3,500
Totals	$ 700	$1,400	$ 1,900	$ 2,100	$ 6,100

[a]/Taxes paid by the owners include tax on other income as follows:

	Calendar Year				
Day:	1956	1957	1958	1959	Total
Wife's salary from firm	$ 300	$ 200	$ 300	$ 500	$ 1,300
Other income (net)	500	(200)	-0-	-0-	300
Total	$ 800	$ -0-	$ 300	$ 500	$ 1,600
Dunn:					
Wife's salary from firm	$ 1,900	$ 2,400	$ 3,100	$ 2,500	$ 9,900
Other income (net)	300	-0-	200	700	1,200
Total	$ 2,200	$ 2,400	$ 3,300	$ 3,200	$11,100

The tax paid by owners is also affected by the amount of their itemized personal deductions, exemptions, the portion of income reportable as capital gain, etc. Exact computations are on file at the University of Nebraska.

The same "other earnings," personal deductions, and exemptions are used for all the computations so the detail and exact nature of these items are not needed for a valid comparison.

lost ground because Day was paid a salary for operating the business, the machinery was reworked, fairly high depreciation was charged to expense, and a following of customers was established.

The earnings and taxes paid after 1956 are more significant to this study than are prior figures, so are tabulated in Table 12. This table also helps trace the changes which were made in the form of organization and the growth of the firm which were described in the preceding section.

TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

The taxes which were actually paid during the years covered by Table 12 are compared with the taxes which would have been paid if the firm had remained (1) a partnership, (2) a tax-option corporation, (3) a conventional corporation using optimum tax planning, or (4) a conventional corporation using no tax planning, in Table 13. During all of the years prior to 1959, salaries were almost identical with corporate earnings. As a result, the tax would have been nearly the same under any of these forms of organization. The firm has, therefore, virtually achieved the optimum tax planning sought in the analysis of the other case study firms.

TABLE 13
FIRM D
COMPARISON OF TAXES UNDER ALTERNATIVE FORMS OF ORGANIZATION

	Actual Transactions			Tax in Other Forms			
						Conventional Corp.	
Period Ended [a]	Total Sales	Total Income[b]	Total Tax Paid	Partner-ship	Tax-Option Corp.	Optimum Planning	No Planning
1956	$ 26,200	$11,400	$ 700	$ 700	$ 700	$ 700	$ 700
1957	66,700	15,400	1,400	1,400	1,400	1,400	1,400
1958	91,100	16,500	1,900	1,900	1,900	1,900	1,900
1959	115,200	18,200	2,100	2,100	2,100	2,600	2,600
Total	$299,200	$61,500	$6,100	$6,100	$6,100	$6,600	$6,600

[a] See Table 12 for the exact years and forms of organization actually used.

[b] Includes other income of the owners.

Note that the tax in 1959 is $500 higher in both of the corporate forms than in either the tax-option or the partnership form. In the other case study analyses, optimum tax planning usually brought the tax close to the tax in these other forms. Firm D provides the exception in 1959. The reason is that there was a capital gain on the sale of Plant B in 1959. Regardless of whether or not there is optimum tax planning, this sale is taxed in full in the corporate form. In the other forms, only half of the profit is taxed. The exact amount of increase is:

Increase in corporate tax:[1/]		
Income of $2,071.45 at 30% (see note 1 below for explanation of why alternative tax is not used)	$621.44	
Tax actually paid (none, since firm is a tax-option corporation)	-0-	$621.44
Decrease in individual taxes:		
Day	$ 77.84	
Dunn	81.25	159.09
Net increase of tax in corporate form over tax actually paid in 1959		$462.35

SPECIAL FACTORS ILLUSTRATED BY THIS CASE

Sale vs. Contribution of Assets to a Corporation

Since the assets of Plant A were worth considerably more than book value at the time of incorporation, Day and Dunn investigated the possibility of selling the plant to the corporation.

1/An interesting aspect of the alternative computation for capital gains arises here. Since corporate rates start at 30% and the maximum tax on capital gains is ostensibly 25%, one would think that the alternative tax would always result in lower tax for corporations. The following computation of the above $621.44 for Firm D proves that this is not always true:

	Alternative Tax	Regular Tax
Taxable income	$2,071.45	$2,071.45
Adjustment for alternative tax:		
Deduct net long-term capital gains reduced by short-term capital losses	2,665.51	
Portion taxed at regular corporate rates	$ (594.06)	$2,071.45
Tax on above at 30%	-0-	$ 621.44
25% of capital gains deducted above	666.38	-0-
Total tax	$ 666.38	$ 621.44

Had there been no taxable income, the alternative tax could have resulted in up to $666.38 more tax than the regular computation.

Law

The principles governing sale to a controlled corporation have been discussed in detail in the preceding chapters. Unless a transfer to a corporation meets all of the requirements set forth on page 37 in Chapter III, the transfer has to be treated as a sale. If the selling price is higher than the adjusted basis to the former owners, these owners pay tax on the gain and the firm obtains a stepped-up basis for the assets. The only general restrictions are that no loss is allowed to a person who owns more than a 50 per cent interest in the firm, and capital gains treatment is not allowed to the owner if he directly or indirectly owns more than an 80 per cent interest in the firm.[1/]

Method

An effective method of selling Plant A to the corporation would have been to first incorporate only Plant B. Since the formation of the corporation took place soon after the purchase of Plant B, the fair value of the assets would be the amount paid for the plant. The incorporation would be a tax-free one in which the assets of Plant B were contributed in return for stock.

After a few weeks, or months, Plant A could have been purchased by the corporation. The corporation could have issued notes to the owners to pay for the plant. As will be seen in the next few paragraphs, these notes would have to be short-term notes and not long-term bonds. The corporation would have to be prompt in paying interest and principal when due.

Tax saving

Amount.--At the time of incorporation, Plant A was worth at least $7,700 more than book value. As can be seen in Table 11, $3,000 was allocated to equipment and

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[1/]The Code sections involved are:

Disallowance of losses--Sec. 267(b).
Disallowance of capital gains--Sec. 1239.

$4,700 to goodwill.[1/] For purposes of this illustration, however, assume that the entire $7,700 could have been fairly allocated to equipment or other depreciable assets. The tax effect is summarized in Table 14 for three alternative business forms.

The tabulation in Table 14 demonstrates conclusively that there is a definite tax advantage in selling appreciated assets to a firm instead of contributing them in a tax-free exchange.

TABLE 14
FIRM D
NET TAX SAVING FROM SELLING PLANT A TO THE FIRM INSTEAD OF CONTRIBUTING IT IN A TAX-FREE EXCHANGE

	Form of Organization			
		Tax	Conventional Corp. a/	
	Partnership	Option Corp.	Optimum Planning	No Planning
Tax saving to corporation from extra depreciation--$7,700 @ 30%				$2,310
Tax saving to individuals at average rate of 22%:				
From extra depreciation--$7,700 @ 22%	$1,694	$1,694		
From less salary (since bonuses in the optimum tax planning form would be equal to corporate income and extra depreciation reduces corp. income)			$1,694	
Deduct: Capital gains tax which would have to be paid by individuals at time of incorporation	847	847	847	847
Net tax saving	$ 847	$ 847	$ 847	$1,463

[a/] Partially offsetting the saving for the "No Planning" conventional corporation where all profits are not withdrawn as salary is the fact that the cash paid as taxes is not available for dividends so there would be less dividends tax paid by the individuals, or, theoretically at least, less value in the stock if sold, resulting in less tax on sale of stock. These possibilities are too indefinite to warrant consideration in this table. Similarly, consideration is not given to the effect of the interest deduction or the withdrawal of funds as the notes are paid.

[1/] Since the actual incorporation was tax-free, the basis of assets to the corporation remained the same as in the partnership. So, there was no special effort to get as much of the valuation as possible allocated to the depreciable items.

If all profits cannot be withdrawn as salary or interest in the corporate form (the "No Tax Planning" column in Table 14), the saving is more than the 50% saving in the other forms. If Firm D were in the 52%, rather than the present 30% corporate bracket, the gross saving would be $4,004 rather than the $2,310 shown in Table 14, and the net saving would then be $3,157 when the owners are in the 22% bracket. As the owners' tax bracket increases, there is less saving, but there will always be some saving in the conventional corporate form since the maximum capital gains tax is 25%.

Adverse effect on working capital.--On the other hand, the individual capital gains tax must be paid at the time of incorporation while the saving from extra depreciation is spread over the years the asset is depreciated. If there are no profits in those years, there is no saving.

Day and Dunn discussed a sale with their accountant and attorney and decided to forego the comparatively significant tax saving because they did not have the cash with which to pay the immediate capital gains tax. Furthermore, their earnings were not sufficiently well established that they were sure of the future savings from increased depreciation.

Here again is an illustration of how lack of working capital can harm a small business. Had they been able to pay the capital gains tax, they could have doubled the "investment" in that tax in five years since most of the machinery was old and was depreciated at 20%.

Danger That the Notes Might be "Securities"

Law.--Although there is, as was pointed out at the beginning of this discussion, ample statutory authority and clear Treasury Department approval of sale of assets to a corporation so long as there is more than one owner, there is another aspect which must be considered. The Commissioner of Internal Revenue

might "telescope" the "purchase" of Plant A into one transaction with the contribution of Plant B. Then, if the notes given by the corporation to the owners are considered as "securities" the transaction would become a tax-free exchange[1/] and the stepped-up basis would be lost. Worse, if the corporation had elected the Subchapter S tax option, these notes might then be a second class of stock and the election thereby automatically terminated.[2/] It is highly important, therefore, to know whether or not notes or other evidence of debt are going to be treated as "stock or securities" or as "boot."

The word "securities" is not defined in the Code or the regulations, except that the regulations exclude stock rights and warrants.[3/] Most of the court cases relate to instances where the taxpayer was attempting to prove that the notes were securities in order to qualify for tax-free status. However, the courts have concluded rather generally that short-term notes are not "securities" but long-term bonds are. The distinction between short-term notes and long-term bonds is not governed entirely by the number of years, or months, before maturity, but rather is based on an over-all evaluation of the nature of the debt, the degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to cash payment, the purpose

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1/Tax-free exchanges were discussed in Chapter III.

2/Regulations Section 1.1371-1(9) specifically states: ". . . If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock." One of the qualifications for election is that the corporation have only one class of stock. (Sec. 1371(a)(4).

This possibility is explored under the "Penalties" caption.

3/Reg. Sec. 1.351-1(a)(1)(ii).

of the advance, etc.[1/]

Evaluation of Firm D's Position.--It would seem from these criteria that the short-term notes given to the owners in payment for Plant B would not be "securities" so the sale would stand. If the corporation could pay for the assets in cash, there would be no question. On the other hand, the notes have a distinct advantage, especially in the conventional corporation, since payment of the notes gets cash out of the corporation with little chance of the payment being considered a dividend. And, the interest is a deductible expense to the corporation.

This leaves the possibility that the notes might be considered stock or equity capital. The answer to this can be found in the same principles as govern the subject of periodic advances from owners which is discussed in the next subsection.

Advances From Stockholders

Advances to Firm D

Firm D has been plagued by lack of working capital. Part of this was due to the way in which Plant B was purchased. A small down payment was made and the balance was to be paid at the rate of $150 a month plus an extra payment of $1,500

[1/] This summary is based on the leading case of this type--Camp Wolters Enterprises vs. Commissioner (22 TC 737 (no. 94), App. 230 F (2d) 555; 49 AFTR 283 (P-H); 56-1 USTC 9314 (CCH). Cert. denied 77 Sup. Ct. 39; 352 US 826). In this case a group of citizens had formed a corporation to purchase a World War II army camp from the Government to develop it industrially rather than have it revert to its original owners. Four days after incorporation the corporation issued 89 non-negotiable, unsecured, installment notes in exchange for the assignment of the contract and restoration rights (in effect selling the land to the corporation). The Court concluded that the contract and restoration rights "constituted permanent contribution to the petitioners' business, not merely temporary advances" and that the notes were therefore securities.

For a readable discussion, see Paul and Kalish "Transition from a Partnership to a Corporation"; New York University Proceedings of Eighteenth Annual Institute on Federal Taxation (1959) pages 642-648.

each January. The burden of these payments can be visualized by studying the balance sheets at the date of incorporation in Table 11 and the earnings summarized in Table 12.

In order to allow the corporation to pay its bills, the owners dug into their savings and borrowed on their life insurance policies, then loaned the proceeds to the corporation. These loans were made from time to time as the need for funds became urgent. The dates and amounts of the loans were:

Date	Dunn	Day
August, 1957 . . .	$ 500	
December, 1957 . .	500	
March, 1958 . . .	250	
June, 1958	925	
June, 1958	200	
June, 1958	800	
December, 1958 . .	1,000	$1,500
December, 1958 . .	500	
January, 1959 . .	500	
Total	$5,175	$1,500

Possible Internal Revenue Service Challenge

Whenever a closely-held corporation borrows from its officer-stockholders, the Internal Revenue Service is apt to raise the question of whether the loans are really contributions of equity capital rather than true loans. This does not mean that officers or stockholders cannot loan money to their corporation. It simply means that they must be sure that the real nature of the loan is easily discernible.

Type of tests.--If a note really represents a loan, the Commissioner of Internal Revenue will expect the interest to be paid when due and the note to be paid at maturity. He will look behind the form of the note to try to find the

substance of the transaction.[1/] He will look at the amount of debt in comparison to equity capital, or, as it is often expressed, the degree of thinness.[2/] At one time, many authors suggested that so long as the debt was not more than 3½ to 4 times the equity capital the Internal Revenue Service would not challenge the debt. This test can no longer be relied on.

While the ratio of debt to equity is an important factor, more weight in current cases is being placed on "substance over form" type of tests and upon a newer group of tests sometimes referred to as the "risk of business" type of test in which inquiries such as the following are made: (1) Did the stockholders really intend the loans as "part of the permanent capital structure?"[3/] (2) Were the loans made before the firm had established an earnings record or credit rating?[4/] (3) Would a disinterested party have made the loans?[5/] (4) Was there a genuine intent to pay the interest and principal?[6/] (5) Are the loans and stock owned

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[1/]For examples of the wide variety of factors considered by the courts, see: Schnitzer vs. Commissioner, 13 TC 113, Aff'd 183 F (2d) 70, cert. denied 340 US 911, S. St. 291 (p. 68); Ruspyn Corporation, 18 TC 769; Gilbert vs. Commissioner, TC Memo 1958-8 Oprior TC Memo 1956-137 remanded 248 F (2d) 399). There are many other cases, but the first two are often cited cases which summarize the kinds of tests used by the courts in their opinions, and the latter case is a recent one which indicates something of current thinking. It sets forth a list of seven factors which the court considers basic.

[2/]For a comprehensive treatment with an analysis of court cases, see Lore, Thin Capitalization. There are many articles and chapters in books on the subject. For an effective, recent, short treatment, see: Morris, "Intent Test Grows . . ." 13 Journal of Taxation 130 (Sept., 1960); or "Thin Incorporation: The Major Tests of Debt or Equity Financing" in the "Notes" section of Volume 4 of 1959 Washington University Law Quarterly.

[3/]See: Poindexter, "Thin Incorporation" 35 Taxes (Nov., 1957).

[4/]Joseph H. Reed, TCM 1955-125.

[5/]Matthiesen, Commissioner vs., 194 F (2d) 661.

[6/]Hogult Real Estate Corp., 30 TC 55.

in the same proportion?[1] (6) Are there assets purchased out of capital funds which could be used to repay the debt?[2] and many similar questions designed to give an indication of whether or not the "loan" is actually a loan or is really being risked in the business.[3]

Firm D Safe from Challenge

Advances.--There should be no question about the advances from Day and Dunn being accepted as bona fide loans. They are clearly within the type of loan sanctioned and approved by the Treasury Department and the Internal Revenue Service. Nevertheless, the firm should be careful to keep interest paid when due and to pay the notes at maturity. If they cannot be paid, they should be formally renewed. In other words, the notes must be handled just as loans from outsiders would be handled.

If Plant A had been purchased.--Similarly, under the hypothetical situation in which Plant A was sold to the corporation, the short-term notes would seem to meet the tests used to determine the genuineness of the notes as loans. However, the transaction approaches the area where a question might be raised. If Firm D had elected this method, everything should be made to point to a real loan rather than equity capital under the guise of loans.

Since Firm D is pressed for working capital, they would need to have a source of funds with which to pay the notes when due before embarking on this route.

Penalties

Although Firm D's advances and notes from stockholders are relatively safe

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1/Leach Corporation, 30 TC 54.

2/Edward G. Janeway, 2 TC 197 (aff'd 147 F (2d) 602) An old case quoted frequently the past few years.

3/For a concise summary, see Weyher and Weithorn, "Capital Structure of New Corporations," pages 287-298.

from successful challenge, it is interesting to see what would happen if the Internal Revenue Service should disallow them. First, the interest payments would become dividends. This would have little tax effect under the tax-option election, but would be serious as a conventional corporation since the corporation would lose the deduction, but the individuals would still pay tax (except for the $50 exclusion and the 4% credit). Second, payment of principal of the notes as they came due might be considered dividends. This would not affect the corporate tax, but would increase the individual taxes. Third, the notes would be treated as a second class of stock. This would automatically terminate the tax-option election. All distributions from the firm would then be fully taxable even though the owners had already paid tax on them as undistributed earnings of the tax-option corporation.

This latter factor is analyzed in detail in the illustrations of terminations of the tax-option election in Chapters VII and VIII.[1/]

While these "penalties" seem severe, there is little to fear so long as the notes are really intended as loans and so long as they are really treated as loans. The Internal Revenue Service recognizes the right of the small corporation to have both debt and equity in their structure. All they try to prevent is the attaining of a tax advantage by making something appear to be what it is not.

Taxes Which Would Have Been Paid if Two Corporations Had Been Formed

Many articles on tax planning state that income taxes can be reduced by forming

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[1/]For an expanded discussion of these penalties (other than under Subchapter S) see Weyher and Weithorn, "Capital Structure of New Corporations," starting on page 288. They inquire into additional "penalties" which occur when owners sell the security at a loss (become capital losses instead of bad debts), the effect on the penalty tax on unreasonable accumulation of surplus, possible effect when the debt was created by exchange of stock for the debt and similar factors too complex for treatment in this report.

several corporations. This is not necessarily so. Firm D produces an illustration of a common situation in which one corporation is better than two or more.

Sound Business Reason

Before examining the tax differential between one and two corporations, it is well to emphasize that business cannot indiscriminately form new corporations each time they approach the $25,000 net income dividing line between the 30 per cent and the 52 per cent corporate tax brackets. There must be a sound business reason for forming separate corporations or the Treasury Department may tax them as if they were one. Firm D, however, would have a sound business reason. The two businesses were acquired at different times, were located in different towns, and were, at the time of acquisition and for two years thereafter, operated as separate businesses.

Amount of Additional Tax

The tax which would have been paid if organized as two corporations is summarized in Table 15. This computation is based on the tax which would have been paid as a conventional corporation rather than as tax-option, pseudo corporation under Subchapter S. If the tax-option alternative is used, breaking a firm into two or more corporations is meaningless because all income is taxed to the owners anyway.

The additional tax which would have resulted from organizing as two corporations is:

Tax as two corporations (from Table 15):		
Year ended July 31, 1957	$ 526	
Year ended July 31, 1959	1,461	$1,987
Tax as one corporation (as tabulated on page 93. The only year in which tax would have been paid is 1959)		621
Tax cost of organizing as two corporations		$1,366

TABLE 15
FIRM D
TAXES WHICH WOULD HAVE BEEN PAID AS TWO CORPORATIONS

	October 1, 1956 to July 31, 1957		August 1, 1957 to July 31, 1958		August 1, 1958 to July 31, 1959	
	Plant A	Plant B	Plant A	Plant B	Plant A	Plant B
Sales	$26,500	$40,300	$30,500	$60,600	$23,100	$92,100
Processing costs[a]	22,000	38,900	27,900	56,800	19,100	89,500
Gross Profit	$ 4,500	$ 1,400	$ 2,600	$ 3,800	$ 4,000	$ 2,600
Selling, Admin. & other expenses	2,700	3,200	2,600	3,700	1,400	5,800
Taxable at Ordinary Rates b/	$ 1,800	$(1,800)	-0-	$ 100	$ 2,600	$(3,200)
Gain on sale of assets				200	2,700	
Net Profit (Loss) b/	$ 1,800	$(1,800)	-0-	$ (100)	$ 5,300	$(3,200)
Corporate tax at 30%[c]	$ 526	-0-	-0-	-0-	$ 1,594	-0-
Alternative tax					$ 1,461	

a/Owners' salaries are included in processing costs.

b/Losses are indicated by parentheses ( ).

c/Tax is based on exact dollars of income instead of on nearest hundred dollars which is used in the top part of this schedule for ease of reading.

However, the $1,366 tax cost would be modified by several factors. First, the Plant B corporation has accumulated a net operating loss which would be available as a carryforward for five years. If the firm shows a profit within five years from the year of loss, the loss would reduce tax in the year to which carried. Second, if Plant A had been organized as a separate corporation, it would likely have been liquidated at the time of sale. If this had been done, the firm could have elected to let the stockholders pay tax on the gain on sale of assets.[1] This would reduce the corporate tax by 25% of the capital gain of $666.

1/Internal Revenue Code Sec. 337. The basic provisions of this section first appeared in the 1954 Code and are intended to eliminate the double taxation which resulted when a corporation sold its assets then distributed the proceeds. Prior to enactment of this provision, stockholders were anxious to sell their stock in

Generalization

Since the corporate rates are 30% on the first $25,000 of taxable income and 52% on income above $25,000, it is obvious that Firm D could not have gained any tax advantage by forming two corporations. A general rule which can be derived from the study of Firm D is that multiple corporations should not be used unless the combined income is more than $25,000 and none of the firms operate at a significant loss.

SUMMARY

The analysis of Firm D afforded an opportunity to observe the organizational changes of a firm which moved from a proprietorship to a partnership to two partnerships, to a corporation, to a tax-option, pseudo corporation under Subchapter

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a corporate business rather than to have the corporation sell the business while the purchasers often wished to purchase the business without the corporation.

Section 337 solved most of the dilemma by eliminating the corporate capital gains tax for those sales where:

1. The corporation adopts a plan of complete liquidation, and
2. All of the assets are distributed within 12 months of adoption of the plan.

A few assets can be held longer than 12 months to meet claims.

Since the corporate capital gains tax is eliminated the tax saving is 25% of the profit. However, it is highly important that all the technical provisions of the section be met. So, a corporation which plans to sell its business should consult its attorney and accountant before any steps are taken. The wording of the resolution adopting the plan is especially important.

Prior to 1954 when the purchaser wanted to purchase the assets, but not the capital stock of the corporation, the selling stockholders would often attempt to first liquidate the corporation by distributing the assets, then sell the assets individually. This type of maneuvering is no longer needed if care is taken to fulfill the requirements of Section 337.

For an expanded discussion of Section 337, see Shockey and Sweeney, Tax Effects of Operating as a Corporation or Partnership, pp. 178-182, and page 26 in Chapter II.

S. Earnings and salaries were such that there would have been little difference in tax under any form of organization prior to 1959. In 1959 one of the plants was sold and the conventional corporate form would have proved costly because corporatio are not allowed the long-term capital gains deduction.

Three special factors were illustrated in terms of Firm D. First, it was suggested that a significant tax saving could have resulted if Plant A had been sold to the corporation instead of being contributed in a tax-free exchange.

The second special factor concerned short-term loans and advances by the stockholders. This analysis led to the conclusion that the advances and notes which were made would have been all right for Firm D, but a clear warning was sounded that such notes must really and truly be loans and not equity capital in disguise. The penalty for getting caught in such a subterfuge is severe.

The third special factor studied led to the conclusion that a firm should not consider formation of multiple corporations unless corporate taxable income is over $25,000 and none of the businesses operates at a significant loss.

CHAPTER VII--FIRM E

LARGE LOSSES IN THE FIRST YEARS OF OPERATIONS

Special Analyses:
Net Operating Loss Deduction
Basis of Partnership Interest as Limit on Deductibility of Losses
Losses on Small Business Corporation Stock

Few businesses are lucky enough to earn profits from the start. Many firms have to go through a period of months or years of losses before they are able to show profits. Others never make sufficient profits so fail or dissolve. The proprietor who forms a partnership or corporation as he takes another person into part-ownership of his business should recognize these probable losses and utilize a form of organization which will permit maximum tax advantage to be taken of these losses if they develop.

There are two broad groups of provisions in our revenue laws which are particularly applicable to new organizations which may suffer losses. One group of provisions permits losses of one period to be carried to other periods to obtain refunds of tax previously paid or to reduce future taxes. The net operating loss deduction and the capital loss carryover are the main provisions of this type. The second group of provisions allows losses on certain small corporation stock to be deducted as an ordinary loss rather than a capital loss.

Firm E sustained large losses during the twelve months it was in existence. The experience of Firm E is accordingly used in this chapter to analyze and demonstrate the loss provisions applicable to new organizations.

HISTORY OF THE FIRM

How the Firm Was Formed

Frank Eastman built his business from a service conducted from a small building back of their home into the largest business in their small town. He and Mrs.

Eastman started the business during the depression days of the 1930's and built it slowly and carefully. In 1956, their doctor told them that they must both retire from the business as soon as possible.

Eastman sold the business to his son, Joe, and to William Evans the latter part of February, 1957. Evans is Joe's father-in-law. Mr. and Mrs. Frank Eastman retained the building and equipment and leased them to the partnership which was formed by Joe Eastman and William Evans. In addition, they accepted notes for part of the selling price of the business.

Details of Purchase of the Business

The business was purchased for the cost of the inventory and the book value of a truck, plus approximately $300 goodwill to bring the price to a round amount. The transaction can be summarized most easily with the opening balance sheet of the firm. The amounts are the costs at which Frank Eastman carried the assets on his books. As is true in all of the case study chapters, amounts are rounded to the nearest hundred dollars.

TABLE 16
FIRM E
OPENING BALANCE SHEET IN FEBRUARY, 1957

Assets:		
Inventories		$25,900
Demonstrator and service truck		2,800
Goodwill		300
		$29,000
Liabilities:		
Accounts and contracts payable		$ 9,000
Owners' Equity:		
Joe Eastman	$10,000	
William Evans	10,000	20,000
		$29,000

Evans made a cash payment to Frank Eastman of $7,500 and gave a note to him

for the remaining $2,500. Joe Eastman simply gave a note for $10,000 to his parents. Thus, they received:

Cash		$ 7,500
Notes:		
From Evans	$ 2,500	
From Joe Eastman	10,000	12,500
Total Selling Price		$20,000

The Eastmans made a gift to Joe in the form of $4,000 credit on his note, leaving $6,000 balance due from him.[1/]

Earnings:

Firm E suffered spectacular losses. The basic reason for these losses is that too large trade-in allowances on used equipment were made. Sales were three times as high as they had been in the previous year when the firm was operated by Frank Eastman, yet a large loss was incurred. This is reflected in Table 17 where sales and net profits for the last three years the firm was operated by Frank Eastman and during the twelve months the business was operated by Firm E are summarized.

TABLE 17
FIRM E
SALES AND PROFITS OF THE BUSINESS

	Sales	Net Profit (Loss)
While Operated by Frank Eastman:		
1954	$155,000	$ 4,600
1955	131,300	3,900
1956	101,400	2,700
1957 (2 months)	30,100	(2,500)
While Operated by Firm E:		
1957 (10 months)	303,900	(16,000)
1958 (2 months--dissolved at end of February)	55,000	(12,300)

[1/] Since the transfer was at book value, which was also the tax basis for gain or loss and for depreciation (except for the $300 charged to goodwill), there is no problem along the lines of sales to relatives, basis of property transferred by gift, etc. It should be noted, however, that complicated problems might have arisen had the price been higher or lower than the basis to Joe's parents. This type of problem was studied in connection with Firm B in Chapter IV.

The gross and the net profits and losses sustained during the twelve months the business was operated by Firm E are further analyzed in Table 18.

TABLE 18
FIRM E
LOSSES SUSTAINED

	Ten Months of 1957	Two Months of 1958	Total
Sales	$303,700	$ 55,000	$358,700
Cost of Goods Sold	301,300	63,500	364,800
Gross Profit	$ 2,400	$ (8,500)	$ (6,100)
Operating expenses	18,400	3,800	22,200
Net Profit (loss)	$(16,000	$(12,300) a/	$(28,300)

a/Part of the proportionally greater loss in two months of 1958 was caused by an auction sale at the time of liquidation, and part by the fact that January and February are traditionally low sales months.

The above tables show clearly that Firm E increased sales by selling at prices which were too low. In most instances this came about through too high trade in allowances. As a result the firm was forced to dissolve after twelve months of operations.

Before looking at the alternative organizational forms, it is necessary to find out how the continued losses were financed. Part was by extending credit purchases as far as possible. The remainder was financed by advances from Evans. Those advanced totaled $9,100 until December 31, 1957, and $12,523.52 between the end of 1957 and the time all partnership debts were paid, but are partially offset by assets received in liquidation and a $4,000 note from Joe Eastman, so that net advances were $9,263.18. Evans paid all of the partnership bills which were outstanding at the time of dissolution. During 1957 Joe Eastman drew $4,792.75, since he had no other income on which to live.

TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

Tax Paid

Tax which would have been paid by Firm E and its owners under alternative forms

of organization are summarized in Table 19. The same basic computations were made for this table as for the corresponding table in the other case study chapters. However, more detail is supplied regarding each owner. This is done so as to provide data which is essential to the discussion of net operating losses later in this chapter.

TABLE 19
FIRM E
TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

	Actual Transactions			Tax in Alternative Forms			
						Conventional Corp.	
	Share of Firm E's Income	Other Income	Actual Tax Paid	Partner ship	Tax-option Pseudo Corp.	Optimum Planning	No Planning
William Evans:							
1955		$ (400)	-0-	-0-	-0-	-0-	-0-
1956		1,700	-0-	-0-	-0-	-0-	-0-
1957	$(8,000)	3,100	-0-	-0-	-0-	$ 32	$ 32
1958:							
Ordinary	$(6,200)	$ 8,800					
Liquidation	(5,000)						
Total 1958	$(11,200)	$ 8,800	-0-	-0-	-0-	$ 929	$ 929
Totals	$(19,200)	$13,200	-0-	-0-	-0-	$ 961	$ 961
Joe Eastman:							
1955		$ 3,200	$ 144	$ 144	$144	$ 144	$ 144
1956		3,600	-0-	-0-	-0-	-0-	-0-
1957	$(8,000)	400	-0-	-0-	-0-	464	464
1958:							
Ordinary	$(6,200)	$ 3,600					
Liquidation	5,000						
Total 1958	$(1,200)	$ 3,600	-0-	-0-	-0-	-0-	-0-
Totals	$(9,200)	$10,800	$ 144	$ 144	$144	$ 608	$ 608
Combined:							
1955		$ 2,800	$ 144	$ 144	$144	$ 144	$ 144
1956		5,300	-0-	-0-	-0-	-0-	-0-
1957	$(16,000)	3,500	-0-	-0-	-0-	496	496
1958:							
Ordinary	$(12,400)	$12,400					
Liquidation	-0-						
Total 1958	$(12,400)	$12,400	-0-	-0-	-0-	$ 929	$ 929
Totals	$(28,400)	$24,000	$ 144	$ 144	$144	$1,569	$1,569

Since Firm E operated at a loss, it is to be expected that the partners paid little tax. In fact, the use of net operating loss carrybacks should result in

refunds of taxes paid in 1955 and 1956. However, the partners paid little tax in those years, so there was little tax to refund--a net total of only $144. Evans is a farmer and the drought which plagued Nebraska during those years kept his income low. Joe Eastman worked for a salary, but his exemptions and personal deductions nearly offset his income. The loss did keep Evans from paying a large tax on his farm income in 1958. Without the loss from Firm E, he would have paid a tax of $1,220 in 1958.

Since Firm E's operations resulted in a substantial loss, there is no opportunity to differentiate between "optimum tax planning" and "no tax planning" in the conventional corporate form. The tax in these two forms is therefore the same.

Tax in the corporate form is larger than in the other forms because the losses of the firm are not available as carrybacks to the owners. Had they paid significant amounts of tax in 1956 and 1957, the difference in total tax between the partnership and corporate forms would be pronounced rather than being a mere $1,425.

Unused Losses

Partnership.--The comparison of tax under alternative forms of organization is not fully reflected in the data in Table 19 because Evans had $2,014.27 of net operating losses which were available to be carried forward as long as five years, and Joe Eastman had $894.14 of such losses. In addition, Evans had the $5,000 capital loss of liquidation which is reflected in Table 19, of which $3,865.47 was available as a carryover to the next five years. This latter item results from the fact that capital losses can be deducted only to the extent of $1,000 per year by individuals. He had capital gains of $134.53 in 1958, so $1,134.53 was used that year.

The owners lose the benefit of much of the net operating losses because they had little or no income in 1956 and 1957, but their personal deductions and

exemptions use up a sizable portion of the loss which is available to be carried forward to future years. Even so, there are significant potential reductions of tax in future years.[1/] The actual and the potential tax reduction from the losses are summarized in Table 20 for the partnership form actually used. The mechanics of the application of the net operating loss provision are summarized in the special factors section of this chapter.

TABLE 20
FIRM E
POTENTIAL REDUCTION OF FEDERAL INCOME TAXES BY LOSS CARRYOVERS
IN THE PARTNERSHIP FORM OF ORGANIZATION

	Evans	Eastman	Total
Refund from net operating loss carryback		$144	$ 144
Reduction of tax in 1957 and 1958	$1,251	140	1,391
Potential reduction from carryovers:			
Net operating loss carryover	403	179	582
Capital loss carryover	775		775
Total	$2,429	$463	$2,892

Tax-option corporation.--Since tax-option corporations can pass their net operating losses on to the owners, one would think that the results in that form would be the same as in the partnership form summarized in Table 20. Such is not the case. As is discussed in Chapter VIII, the net operating loss which a stockholder in a tax-option corporation can deduct is limited by the basis of his capital account. Evans would get his loss in full because of the advances which he made to the firm, but Eastman would lose the portion in excess of his capital account basis of $10,000. The net effect is that he would lose the $179 potential reduction reflected in Table 20. The total tax reduction in the tax option form would therefore be $179 less than in the partnership form, or $2,713.

Conventional corporation.--The situation changes when the corporate form is considered. The operating losses could not be passed on to the shareholders, but

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[1/] Nothing is to be gained by seeking out the individual incomes of the owners in 1958 and 1959 since the potential savings is the item which should receive attention.

belong to the corporation. Since the corporation would have been liquidated, these losses would have done no one any tax good. However, the owners would have had sizable capital losses, equal to the cost of their stock plus the advances to the firm which could not be paid back. These capital losses would have been deductible to the extent of $1,000 in 1958 by each, but Evans would still have had an unused capital loss of approximately $18,200 and Joe Eastman would have had an unused capital loss of $13,000.

Under certain circumstances, these unused capital losses could be more valuable than the net operating losses which were available in the partnership form. On the other hand, unless the owners have other capital gains during the next five years, they can each deduct only $1,000 a year or $5,000 of the loss. Thus, the capital loss on dissolution might reduce the tax of the owners as much as the net operating losses did in the partnership, or the capital losses might result in little tax reduction, depending upon whether or not the owners have substantial capital gains within the next five years. The potential tax reduction under both of these possibilities is summarized and compared with the potential reduction in the partnership form in Table 21.

Joe Eastman went to work on a salary after Firm E dissolved. He had no capital gains during 1959 and 1960 and is not likely to have any in the next three years. Evans continued to operate his farm and has had some sales of breeding and dairy stock which are given capital gains treatment under Section 1231 of the Code. His position is somewhere between the two possibilities shown in Table 21 since these sales will probably not be large enough to use up all of the capital loss carryover.

Applicability to Other Firms

There are two unusual circumstances in Firm E which must be kept in mind in

TABLE 21
FIRM E
POTENTIAL REDUCTION OF TAXES IN THE CORPORATE FORM OF ORGANIZATION AND COMPARISON WITH PARTNERSHIP FORM

	Evans	Eastman	Total
Assuming the Owners Have No Capital Gains During the Next Five Years:			
Reduction due to $1,000 net capital loss per year (assuming 20% tax bracket)	$1,000	$1,000	$2,000
Potential Reduction in Partnership:			
From operating losses:			
Carryback refund		$ 144	$ 144
Carryovers	$ 403	179	582
From capital loss carryover	775		775
Excess of tax in corporate form over tax in partnership form (Table 19)	961	464	1,425
Total	$2,139	$ 787	$2,926
Benefit (loss) from being organized as a corporation if owners have no capital gains	$(1,139)	$ 213	$(926)
Assuming the Owners Have Capital Gains During the Next Five Years:			
Reduction due to capital gain carryover (½ the gain at the assumed rate of 20%)	$1,817	$1,300	$3,117
Partnership reduction and saving as tabulated above	2,139	787	2,926
Benefit (loss) from being organized as a corporation if owners have capital gains	$(322)	$ 513	$ 191

evaluating the results of the foregoing study. First of all, the owners' income was so low that there was little benefit from the carryback of net operating loss to the two preceding years, yet they had sufficient income to absorb most of the loss as it was carried from year to year. The second unusual factor is that the firm was liquidated after operating only twelve months, thus providing a capital loss which would not ordinarily enter the picture.

In view of these two special circumstances, and in view of the extra tax which results in the corporate form unless there are huge capital gains by the owners in the next five years, it is obvious that partnership or tax-option corporate taxation is to be preferred over conventional corporate taxation when there will

be operating losses in the first few years of operations.[1/] After profits are reasonably assured, it is sometimes desirable to change to the corporate form.

Two incidental, but important, observations should be made in connection with the comparison in Table 21 and the conclusions drawn in the preceding paragraph. The first is to point out the danger of relying on generalizations. The special circumstances in Firm E when the owners have large capital gains disproves the generalization that the partnership or tax-option form is always best until profits are reasonably assured. Thus it is paramount that each firm compute the tax effect under its own special set of circumstances and not rely on generalizations.

The second observation is that a form of organization which is best for one owner may not be best for another owner. The corporate form would have been best for Eastman, but the partnership form would have been best for Evans. The businessman who is bringing someone into his firm with him should anticipate these differences and allow for them in deciding upon the division of profits, proceeds in case of liquidation, and similar features. All too often these possibilities are ignored when the articles of partnership or corporate by-laws are drawn.

SPECIAL FACTORS ILLUSTRATED BY THIS CASE

As was noted in the introductory paragraphs to this chapter, two problems are analyzed in this section. The first summarizes the application of net operating loss deductions which played such a significant part in the conclusions drawn in the preceding section. The second investigates the effect that the ordinary loss deduction on small corporation stock would have had on the tax paid by Firm E and its owners.

[1/] See the analysis of Firm B in Chapter IV for an example of how the corporate net operating losses can be availed of _if_ the corporation starts making sizable profits within five years.

Net Operating Loss Deduction

Steps in Computation of Net Operating Loss Deduction

The definition of a net operating loss is a simple one: "The excess of deductions . . . over the gross income . . . with the modification specified in subsection (d)."[1/] Subsection (d) specifies the adjustments, or modifications, which must be made. In simple language, they consist of the following for individuals, including partners:

1. No net operating loss carryover or carryback from other years is allowed.
2. The long-term capital gains deduction of 50 per cent must be eliminated (so that 100 per cent of the gain is used in the computation).
3. No personal exemptions are allowed.
4. Non-business deductions are eliminated except to the extent they are offset by non-business income. In connection with this adjustment, the Code specifies that gain and loss on the disposition of real or depreciable property used in business is considered business income, and that casualty losses are not to be included in non-business deductions for this purpose (so they are fully includable).
5. The net capital loss is eliminated.

Since corporations do not receive the long-term capital gains deduction, are not allowed any capital loss, and have no non-business income, there are usually no adjustments for a corporation.[2/]

[1/] Code section 172(c).

[2/] Actually, the statute requires three, but they seldom apply to the small firms studied in this report. The three are:

A. The deduction for dividends received is allowed in full without regard to the limitations otherwise imposed.

B. No deduction is allowed for partially tax-exempt interest or for the special deduction allowed to Western Hemisphere trade corporations.

C. No net operating loss deduction (carryover or carryback from other years) is allowed. This one is obvious but is included in order to be sure that there is no misunderstanding, especially in carryover years.

If any loss remains after the above adjustments in the year of loss, the remainder is deducted directly from the loss of the year to which it is carried, and a refund of the difference between the new tax after the net operating loss deductio[n] and the tax paid is in order.

However, before individuals and partners can carry any unused portion forward to the next year, the adjustments for capital gains and losses must be made and no general exemptions are allowed.

Limitation of Partner's Losses to the Amount of the Adjusted Basis of His Partnership Interest

The 1954 Code introduced a rather unusual provision into the concept of taxation of partnerships. That provision is that a partner cannot deduct any losses which are in excess of the adjusted basis of his partnership interest.

The disallowed losses are not, however, forever lost. They can be deducted in the year in which the loss is made up to the partnership whether that be through profits or through additional contributions.[1/]

The Code sets forth exact steps for computation of the basis of a partnership interest[2/] but the factor which is unusual and which affects the problem studied in this report is the provision in Section 752 which requires that any increase or decrease in the partnership liabilities correspondingly increases or decreases the partners' bases for their partnership interests.[3/]

1/Code section 704.

2/Code section 705.

3/While the soundness or desirability of this provision is not a topic within the scope of this report, it should be noted that many writers do not believe that the provision is either sound or workable. Since the purpose of this paper is to observe what the law is and to determine how it affects the choice of forms of legal organization, the discussion is confined to that aspect of the problem.

The reasoning behind the provision and a suggestion for changing the provision to make it workable are explained in <u>Willis</u>, <u>op</u>. <u>cit</u>.

This provision opens the door to an effective use of the partnership form of organization to minimize the effect of having net operating loss carried to years in which the partner had no tax to pay. In many instances, the partnership can avoid incurring liabilities at the end of the year and so reduce the partners' capital account bases to less than zero. When that happens, the loss is not recognized. The partner can, instead, have the loss realized when he repays the deficit. Thus, he can extend the losses more than five years forward and have them recognized in years in which they will reduce his tax.

In order to make the operation of this provision specific, reference is made to the opening balance sheet of Firm E in Table 16. From an accounting viewpoint, one would think that each partner would have a basis for his partnership interest at the opening date of $10,000. Actually each would have a basis of $14,500, since his capital account would be increased by his half of the liabilities of $9,000.

Losses on Small Corporation Stock

Congress enacted a provision in 1958 which has a significant influence on the proper choice of form of legal organization of those new firms which may suffer losses or even become insolvent and have to liquidate. That provision allows losses on stock of those corporations to be deducted as an ordinary loss, rather than a capital loss, up to $25,000 per year ($50,000 on a joint return). In order for losses to be accorded this special treatment, the stock must have been issued under a plan adopted after June 30, 1958; must be sold, exchanged, or become worthless during the year for which the deduction is claimed; the corporation which issued the stock must have received less than $500,000 from the sale of the stock; and the total equity capital of the issuing corporation must not exceed $1,000,000.[1]

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[1] Other requirements include provisions that the stock must be held by the individual or partnership to whom it was originally issued, and provisions that gross income must not be from certain sources.

Had Firm E been able to use this plan, they might have incorporated, elected the partnership-like taxation under Subchapter S so as to get maximum net operating loss deductions, and been able to deduct the loss on the worthlessness of the stock as an ordinary loss. More important, it is conceivable that had things not gone so badly, the firm may have operated at a small profit but one or both of the owners wanted to get out of the venture. Had he found a purchaser for his stock at a price below what he had invested, he would have had an ordinary loss just as he would have in the partnership form. The sale of an interest in a corporation is often much easier than an interest in a partnership, so this provision points toward increased use of corporations in small business.

The importance of this possibility must not be minimized. To illustrate the possibilities, note that Evans had a capital loss carryover to future years of $18,178.18 and Eastman had a capital loss carryover to future years of $13,000.00. Had the corporate form been used and had the special ordinary loss provision been available, these losses would be ordinary losses which would be part of the net operating loss carryover against ordinary income in future years instead of being a capital loss carryover deductible only against capital gains and limited to a net deduction of $1,000 per year each. The potential reduction of tax would, at 20 per cent rate, be $3,635.63 for Evans and $2,600.00 for Eastman, just double the potential reduction if the owners have capital gains. More important, the reduction is fully available when there are no capital gains.

SUMMARY AND CONCLUSIONS

Firm E provided an opportunity to test a commonly accepted adage that the partnership form of organization should be used by the closely-held firm until profits are reasonably assured. The reason for this is that partnership losses

are available to the partners as net operating loss carryovers and carrybacks, whereas corporate losses are available only to the corporation. Unless the corporation has taxable income within five years, the tax benefit of the losses is lost.

The truth of the above adage is obvious when the firm remains in business and when a conventional corporation is used. However, Firm E liquidated after twelve months. This resulted in there being capital losses on the liquidation as well as net operating losses. Under these conditions, which are often repeated in small business, the adage proved to be only partly true. The partnership form of organization still resulted in the least tax when the owners did not have substantial capital gains in future years. However, when it was assumed that the owners had large capital gains in future years, the corporate form gave the largest tax reduction from the losses of Firm E.

When two features which were new in 1958 are considered, the best form of organization changes. Tax-option corporations can now pass net operating losses through to the owners just as in partnerships, except that deductible losses in tax-option corporations are limited to the basis of the stockholder's capital and loan accounts in the corporation. Disallowed losses are forever lost, whereas in a partnership they can be deducted in the future when the basis is brought up to a positive figure. A second new feature allows individuals to deduct up to $25,000 a year ($50,000 on a joint return) of losses on qualified small corporation stock as an ordinary deduction rather than as a capital loss. This gives an advantage over the partnership form in some instances where an interest is sold. On liquidation, there should be little difference, although special factors operated in the instance of Firm E to give a decided advantage to the corporate form using these two special features.

As a general conclusion it can be said that the tax will be about the same in the partnership form or in the corporate form with Subchapter S and Section 1244

(ordinary loss on stock) provisions in effect, unless losses are in excess of the basis of an owner's total interest. Special circumstances can vary this conclusion however.

Since the corporate form can have the same, or even less, tax than the partnership form when these two special features are availed of, the corporate form has considerable appeal to small businesses even though they suffer losses. The appeal will be from the financial, control and managerial features of the corporation. Before 1958, the corporate form was apt to be costly from a tax viewpoint. It still is when the two special features cannot be availed of. So, the old adage referred to in the first paragraph of this section is valid except for those small firms which can elect Subchapter S tax-option and the ordinary-loss-on-stock provisions.

CHAPTER VIII--FIRM F

INDUCTION OF AN EMPLOYEE INTO OWNERSHIP
Special Analysis: Basis Problems Under Subchapter S

This chapter is devoted to an analysis of the organizational forms which were used as Al Field brought his brother-in-law, Roy Fox, into his business as an employee, then moved him to a full partner in a new venture, to a partner in both businesses, to one of the stockholders in a close corporation to which both businesses were transferred.

The special analysis section is devoted to problems involving the basis of the assets as they are moved from one form of organization to another. Special attention is given to the limitations imposed on net operating losses of Subchapter S tax-option corporations by the basis of the stockholders interests and a comparison of the tax and accounting treatment of such losses. This comparison reveals some surprising applications.

HISTORY OF THE FIRM

General

The business which Firm F now operates started in the basement of Al Field's home. In 1953 Roy Fox joined the firm as an employee. The two men found that they worked well together, so in March 1954, a new venture was started in which the two men were equal partners. During that first year, the following amounts of capital were contributed:

Field	$3,150.37
Fox	857.83
Total	$4,008.20

The men were exceedingly careful to keep the business of the two ventures entirely separate during the first few years of operations. As the new venture grew, Fox spent less and less time working for Field, and his salary was correspondingly reduced.

As time went on, however, they became careless and found that the affairs of the two firms often became entangled on the books. Orders which should have belonged to one of the ventures were filled from the stock of and were collected through the other venture. Occasionally the cash would get mixed up. So, in late 1957 Field and Fox decided to combine the two businesses into one partnership. Starting on January 1, 1958, Field contributed his proprietorship business to the partnership. They agreed that Field was to receive sixty per cent of the profits of the expanded partnership and Fox forty per cent.

In December, 1958, Field and Fox formed a corporation and contributed the partnership business to this corporation. This was done primarily to receive the business advantages of the corporate form. The various forms of organization can be readily traced by inspection of the income statements in Table 23.

TABLE 22
FIRM F
CONDENSED BALANCE SHEET
December 31, 1959

Assets:		
Cash		$12,100
Inventories		2,200
Equipment:		
Cost	$42,000	
Portion charged to expense (depreciation)	12,300	29,700
Organization expense:		
Amount spent	$ 300	
Portion charged to expense (amort.)	100	200
Total assets		$44,200
Liabilities:		
Accounts payable		$ 9,400
Accrued expenses		200
Notes due to stockholders		24,300
Total liabilities		$33,900
Stockholders Equity:		
Common stock	$10,000	
Retained earnings	300	10,300
Total liabilities and equity		$44,200

TABLE 23
FIRM F
CONDENSED INCOME STATEMENTS

	1954	1955	1956	1957	1958	1959
Original Proprietorship						
Sales	$59,200	$64,900	$55,200	$52,600	-0-	
Cost of goods sold	34,600	40,700	33,700	38,600		
Gross profit	$24,600	$24,200	$21,500	$14,000		
Operating expenses	13,000	12,500	12,200	7,900		
Net profit (loss)	$11,600	$11,700	$ 9,300	$ 6,100	$(1,500)	
Division of net income:						
Field--100%	$11,600	$11,700	$ 9,300	$ 6,100	$(1,500)	
Branch Partnership						
Sales	$ 3,900	$12,700	$41,400	$60,600		
Cost of goods sold	2,300	5,900	25,500	36,100		
Gross profit	$ 1,600	$ 6,800	$15,900	$24,500		
Operating expenses	500	1,800	3,700	6,500		
Net income	$ 1,100	$ 5,000	$12,200	$18,000		
Division of net income:						
Field--50%	$ 550	$ 2,500	$ 6,100	$ 9,000		
Fox--50%	550	2,500	6,100	9,000		
Consolidated Partnership						
Sales					$124,500	
Cost of goods sold					74,900	
Gross profit					$ 49,600	
Operating expenses					17,800	
Net profit					$ 31,800	
Division of net income:						
Field--60%					$ 19,100	
Fox--40%					12,700	
Corporation						
Sales						$137,900
Cost of goods sold						83,800
Gross profit						$ 54,100
Operating expenses:						
Officers' salaries						24,700
Other						28,900
Total						$ 53,600
Net profit						$ 500

Financial History

Firm F is not a large business, but it provides a good income for the owners and has been able to finance its own expansion without outside help. Some idea

of the size of the business can be obtained by examining the condensed balance sheet in Table 22.

The earnings statements of each organization since 1954 are summarized in Table 23. This statement shows that the firm has recently been earning in the area of from $25,000 to over $30,000 per year. Since the investment by the owners is only about $35,000,[1/] Firm F is clearly a financial success. It provides another example of the fact that young men who are willing to make up for a lack of capital with long hours of work and who are willing to try new ideas can build a new business.[2/]

TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

The tax which would have been paid by Firm F under some of the possible alternative forms of organization is summarized in Table 24. Some data is summarized from Table 23 in the first three columns of Table 24 in order to make comparison easy without turning back and forth between tables.

Several assumptions had to be made for certain of the computations. These assumptions are summarized in the footnotes to the table.

The comparison in Table 24 is a bit startling because it shows that tax under the Subchapter S tax-option corporate form is $700 higher than the tax in either the partnership form or the conventional corporate form when optimum tax planning is carried out. The tax in the latter two forms appears to be the same, but actually is not. When exact amounts, rather than amounts rounded to the nearest hundred dollars are examined, there is a difference of $42.41. This result indicates that the firm has achieved maximum tax planning.

[1/]Stockholders equity plus notes to stockholders in the balance sheet in Table 22.

[2/]This does not mean that capital is not important. A man with no or little capital is excluded from many lines of business. But there are, as Firm F proves, businesses where large capital is not essential.

TABLE 24
FIRM F
TAXES UNDER ALTERNATIVE FORMS OF ORGANIZATION[a]

	Actual Transactions			Tax in Alternative Forms			
					Tax Option	Conventional Corp.	
Year	Total Sales [b]	Total Income[b]	Tax Paid	Partnership	Pseudo Corporation	Optimum Planning	No Planning
1954	$ 63,100	$ 15,100	$ 2,100	$ 2,100	$ 2,600	$ 3,500	$ 2,300
1955	77,600	16,700	2,800	2,800	3,000	3,300	4,000
1956	96,600	23,200	3,800	3,800	3,800	2,600	5,300
1957	113,200	26,000	3,900	3,900	3,900	3,200	6,600
1958	124,600	31,800	5,700	5,700	5,700	5,600	15,000
1959	137,900	26,300	3,800[c]	3,700	3,700	3,800	5,900
Totals[d]	$613,000	$139,100	$22,100	$22,000	$22,700	$22,000	$39,200

[a]The alternative forms of organization are considered for only the business in which both owners had an interest--that is, the income from the business owned by Field is considered with his personal income until 1958 when it was actually combined into the partnership.

[b]Total sales and income include income from the proprietorship reported by Field personally until 1958. This is necessary because the total tax paid includes Field's tax on this income. Net income includes salary paid by Field to Fox and by the corporation to both owners.

[c]Tax paid in 1959 includes tax on bonuses accrued to corporation in 1959 but not paid and reported by owners until 1960. This is necessary in order to compare with partnership and pseudo-corporation tax.

[d]Totals may not add due to rounding. Totals are based on exact computations.

The fact that tax in the tax-option form is $700 higher than in the partnership form points out one of the serious disadvantages of the Subchapter S election. When that election is in effect, losses in excess of the basis of the stock in a corporation cannot be deducted and are forever lost. So, since Fox had little capital to contribute, but since he is allocated a salary, the hypothetical corporation would have had a loss in 1954 and 1955. Fox would have received no tax reduction for part of his portion of the loss. This explains why the tax-option tax was $500 greater in 1954 and $200 greater in 1955 than in the partnership form. This phenomenon is analyzed in more detail in the next section of this report.

SPECIAL FACTORS ILLUSTRATED BY THIS CASE

Nature of Problem Studied

One of the most troublesome areas in the application of the partnership-like taxation election available to some small corporations under Subchapter S of the Internal Revenue Code is the application of the "basis" provisions. The demonstration in this section will show that these provisions work out in simple and logical fashion under ideal conditions. However, when there are losses in excess of investment, the result is quite different than casual observation would lead one to suspect.

This basis provision is no more important than several other provisions of Subchapter S, but is used as an example of how provisions which were written into the statute with certain relationships in mind can create serious and unforeseen hardships under other conditions.

Normal Situation

Law

The Internal Revenue Code provides, as part of Subchapter S, for adjustment of the basis of a stockholder's stock for undistributed taxable income which is left in the firm but which is taxed to the stockholder. Similarly, dividends reduce the basis of the stock.[1/] Normally this has the effect of keeping the basis equal to the investment which the stockholder has in the corporation. The effect of the upward adjustment for undistributed taxable income is the same as if the income had been distributed at the end of the year, then been recontributed to the firm.

Analysis

The effect of the usual adjustments to the basis of stock is demonstrated by

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1/ Section 1376 and Regulations Sec. 1.1376.

the analysis of Al Field's capital accounts in Table 25. That table provides a comparison of his capital account in the actual partnership with the basis of his stock in the hypothetical corporation. In order to provide as realistic a picture as possible, a salary of $3,600 is assumed throughout the period, but it is assumed that the difference between this assumed salary and actual withdrawals is loaned back to the firm.[1] This is done in order to keep the invested capital at the same amount as actually existed in the partnership. In order to be sure that there is no misunderstanding as the statement is studied, the salary is shown as an addition to the loan account each year and the actual withdrawals are shown as a repayment of part of the loan. Note that the withdrawals finally caught up with this assumed salary in 1957 so that the loan was thereby paid in full.

Important Findings Reflected in Table 25

Two significant facts revealed in Table 25. First, the sum of the second and third columns (tax basis in tax-option corporate form--capital account, and loan account) is always equal to the balance in the actual partnership capital accounts which is reflected in the first column. Second, the income taxable to Field is exactly the same for the partnership and the tax-option corporate form. This proves that the basic law is sound and logical. This is hard to visualize from reading of the statute since the language is of necessity complex and difficult. The real intent and purpose of the rules can best be understood only by making a study of the type summarized in Table 25. When that is done, it is easy to see that the basis rules are simply designed to conform the tax-option situation to the regular accounting treatment of a partner's capital account.[2]

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[1] It must always be remembered that the Internal Revenue Service will examine the substance of a series of transactions to see what really happened. It is essential, therefore, that loans not be tied to withdrawals and distributions and that they be bona fide separate and distinct transactions.

The purpose of the demonstration in this Chapter is to analyze the basis provisions of the Code. The loan assumptions do not necessarily indicate the propoer way to handle loans, or that loans under such circumstances are valid.

[2] This does not mean that the basis of a partnership interest follows this same logical pattern, because it does not. See, for example, the analyses in Chapters IV and VII.

TABLE 25
FIRM F
COMPARISON OF BASIS OF INVESTMENT IN
TAX OPTION CORPORATION WITH ACTUAL PARTNERSHIP ACCOUNT
Original Owner--Field

		Actual Partnership Capital Account	Tax Basis in Tax-Option[a/][b/] Corporate Form: Capital Account	Tax Basis in Tax-Option Corporate Form: Loan Account	Taxable Income: Actual Partnership Form	Taxable Income: Tax Option Corporate Form
Balances March, 1954		-0-	-0-	-0-		
Investment during 1954		$ 3,150.37	$ 3,150.37			
Field's share of 1954 profit:						
Per partnership books	$ 556.57	556.57			$ 556.57	
Assumed salary	3,600.00			$3,600.00		$ 3,600.00
Corp. net operating loss	$(3,043.43)		(3,043.43)			(3,043.43)
Totals		$ 3,706.94	$ 106.94	$3,600.00	$ 556.57	$ 556.57
Withdrawals during 1954		200.00		200.00		
Balances December 31, 1954		$ 3,506.94	$ 106.94	$3,400.00		
Investment during 1955		1,596.85	1,596.85			
Field's share of 1955 profit:						
Per partnership books	$ 2,494.92	2,494.92			$ 2,494.92	
Assumed salary	3,600.00			3,600.00		3,600.00
Corp. net operating loss	$(1,105.08)		(1,105.08)			(1,105.08)
Totals		$ 7,598.71	$ 598.71	$7,000.00	$ 2,494.92	$ 2,494.92
Withdrawals during 1955		3,159.31		3,159.31		
Balances December 31, 1955		$ 4,439.40	$ 598.71	$3,840.69		
Investments during 1956		-0-				
Field's share of 1956 profit:						
Per partnership books	$ 6,086.05	6,086.05			$ 6,086.05	
Assumed salary	3,600.00			3,600.00		$ 3,600.00
Corp. undist. taxable inc.	$ 2,486.05		2,486.05			2,486.05
Totals		$10,525.45	$ 3,084.76	$7,440.69	$ 6,086.05	$ 6,086.05
Withdrawals during 1956[c/]		3,630.08		3,630.08		
Balances December 31, 1956 (forward)		$ 6,895.37	$ 3,084.76	$3,810.61		

TABLE 25

FIRM F

		Actual Partnership Capital Account	Tax Basis in Tax-Option a/ b/ Corporate Form: Capital Account	Tax Basis in Tax-Option a/ b/ Corporate Form: Loan Account	Taxable Income: Actual Partnership Form	Taxable Income: Tax Option Corporate Form
Balances December 31, 1956		$ 6,895.37	$ 3,084.76	$3,810.61		
Investment during 1957		-0-				
Field's share of 1957 profit:						
Per partnership books	$ 9,023.81	9,023.81			$ 9,023.81	
Assumed salary	3,600.00			3,600.00		$ 3,600.00
Corp. undist. taxable inc.	$ 5,423.81		5,423.81			5,423.81
Totals		$15,919.18	$ 8,508.57	$7,410.61	$ 9,023.81	$ 9,023.81
Withdrawals during 1957		3,012.02		3,012.02		
Balances December 31, 1957		$12,907.16	$ 8,508.57	$4,398.59		
Inv. in 1958 (assets of prop.)		10,744.32	10,744.32			
Field's share of 1958 profit:						
Ordinary income	$19,083.56					
Long-term capital gains	4,801.31					
Total per tax return	$23,884.87				$23,844.87	
Unallowable deductions	1,599.74					$ 1,599.74
Net income per books	$22,285.13	22,285.13				
Assumed salary	3,600.00			3,600.00		3,600.00
Corp. undist. taxable inc.	$18,685.13		18,685.13			18,685.13
Totals		$45,936.61	$37,938.02	$7,998.59	$23,884.87	$23,884.87
Withdrawals in 1958		18,245.28	10,246.69	7,998.59		
d/ ----------						---------- d/
Cap. to corp. org. in Dec. 1958 d/		$27,691.33	$27,691.33	-0-		
Field's share of 1959 profit:						
Corp. ordinary income	$ 293.81		293.81			$ 293.81
Bonus paid at end of year (treated as dividend from cur. inc. in tax-option corp. computations)	5,100.00					5,100.00
Salary	9,000.00					9,000.00
Partnership income	$14,393.81	$14,393.81			$14,393.81	$14,393.81
Totals		$42,085.14	$27,985.14	-0-		
Withdrawals		14,100.00				
Balances December 31, 1959		$27,985.14	$27,985.14	-0-		

TABLE 25
FIRM F

a/Subchapter S, which first allowed the tax-option election, was not enacted until 1958. The computations herein nevertheless assume that the election was available throughout the period in order to show the effect of the present law.

b/It is assumed that the capital contributions to the partnership are the cost of the stock owned, even though odd dollars and cents would not ordinarily be paid for corporate stock. This is done so as to correlate with the data in Table 24.

c/Actual transactions include a loan in 1956 but for simplification of presentation all advances and withdrawals are treated as having been handled through the capital accounts.

d/Since a corporation was formed in December, 1958, to take over operation of the firm January 1, 1959, the partnership figures below the dotted line are a hypothetical partnership using actual corporate figures. The computation of income and similar items must, of necessity, proceed differently for 1959 than for other years.

Losses Which Affect Basis of Loans

Comparison With Normal Situation

There is a second provision in the basis rules under Subchapter S which is developed from the logical method demonstrated by Al Field's accounts, but which is not logical and can result in extreme hardship. This entirely different and inequitable result can be demonstrated by examining what would have happened to the other partner in Firm F--Roy Fox. Accordingly, the same analysis was made for his capital and loan accounts as was made for Al Field's accounts, using the same assumptions and procedure. The results are summarized in Table 26.

Important Findings Reflected in Table 26

The results reflected in Table 26 are not at all like those in Table 25. The totals of the second and third columns do not equal the first column. Nor is the income taxed to Fox the same under the partnership and the tax-option corporate forms. The obvious conclusion is that the logical idea which works out so well for Field has a flaw in it somewhere.

In order to find the cause of these differences, it is necessary to work through Table 26 line by line. If this is done, it will be noted that the combination of the second and third columns equals the first column through 1957 and that the income taxable to Fox is the same in both the partnership and the tax-option corporate forms. However, the root of the difficulty lies in things which happened before that date. The Code provides that when a tax-option corporation has a net operating loss, that loss reduces the basis of a stockholder's stock.[1/] Thus, going back to the analysis of Field's situation in Table 25, the net operating loss in 1954 was subtracted from the amount which he had invested in the corporation,

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[1/] Code Sec. 1376(b)(1)

TABLE 26
FIRM F
COMPARISON OF BASIS OF INVESTMENT IN
TAX OPTION CORPORATION WITH ACTUAL PARTNERSHIP ACCOUNT
New Owner--Roy Fox

		Actual Partnership Capital Account	Tax Basis in Tax-Option Corporate Form: Capital Account	Tax Basis in Tax-Option Corporate Form: Loan Account	Taxable Income: Actual Partnership Form	Taxable Income: Tax Option Corporate Form
Balances March, 1954		-0-				
Investment during 1954		$ 857.83	$ 857.83			
Withdrawals during 1954		200.00	200.00			
Fox's share of 1954 profit:		$ 657.83	$ 657.83			
Per partnership books	$ 556.57	556.57			$ 556.57	
Assumed salary	3,600.00			$3,600.00		$ 3,600.00
Corp. net operating loss	$(3,043.43)		(657.83)	(2,385.60)		(3,043.43)
Totals					$ 556.57	$ 556.57
Balances December 31, 1954		$ 1,214.40	-0-	$1,214.40		
Investment during 1955		-0-				
Fox's share of 1955 profit:						
Per partnership books	$ 2,494.92	2,494.92			$ 2,494.92	
Assumed salary	3,600.00			3,600.00		$ 3,600.00
Corp. net operating loss	$(1,105.08)			(1,105.08)		(1,105.08)
Totals		$ 3,709.32		$3,709.32	$ 2,494.92	$ 2,494.92
Withdrawals during 1955		1,200.00		1,200.00		
Balances December 31, 1955		$ 2,509.32	-0-	$2,509.32		
Investment during 1956		-0-				
Fox's share of 1956 profit:						
Per partnership books	$ 6,086.05	6,086.05			$ 6,086.05	
Assumed salary	3,600.00			3,600.00		$ 3,600.00
Corp. undist. taxable inc.	$ 2,486.05		$ 2,486.05			2,486.05
Totals		$ 8,595.37	$ 2,486.05	$6,109.32	$ 6,086.05	$ 6,086.05
Withdrawals during 1956		1,700.00		1,700.00		
Balance December 31, 1956 (forward)		$ 6,895.37	$ 2,486.05	$4,409.32		

TABLE 26
FIRM F

		Actual Partnership Capital Account	Tax Basis in Tax-Option Corporate Form: Capital Account	Tax Basis in Tax-Option Corporate Form: Loan Account	Taxable Income: Actual Partnership Form	Taxable Income: Tax Option Corporate Form
Balances December 31, 1956		$ 6,895.37	$ 2,486.05	$4,409.32		
Investment during 1957		-0-				
Fox's share of 1957 profits:						
Per partnership books	$ 9,023.81	9,023.81			$ 9,023.81	
Assumed salary	3,600.00			3,600.00		$ 3,600.00
Corp. undist. taxable inc.	$ 5,423.81		5,423.81			5,423.81
Totals		$15,919.18	$ 7,909.86	$8,009.32	$ 9,023.81	$ 9,023.81
Withdrawals during 1957		3,736.31		3,736.31		
Balances December 31, 1957		$12,182.87	$ 7,909.86	$4,273.01		
Investment during 1958		115.49	115.49			
Fox's share of 1958 income:						
Per partnership books:						
Ordinary income	$12,722.38					
Long-term cap. gains	308.16					
Total entered on tax ret.	$13,030.54				$13,030.54	
Unallowable deductions	1,066.50					$ 1,066.50
Net income per books	$11,964.04	11,964.04				
Assumed salary	3,600.00			3,600.00		3,600.00
Corp. undist. taxable inc.	$ 8,364.04		8,364.04			8,364.04
Totals		$24,262.40	$16,389.39	$7,873.01	$13,030.54	$13,030.54
Withdrawals during 1958		10,013.99		10,013.99		
Balances December 31, 1958		$14,248.41	$16,389.39	$(2,140.98)		
Excess of repayment of part of loan acct. over basis is inc.				2,140.98		2,140.98
				-0-	$13,030.54	$15,171.52
a/						a/
Balances at time of formation of actual corporation		$14,248.41	$16,389.39	-0-		
Fox's share of income for 1959: (forward)						

TABLE 26
FIRM F

		Actual Partnership Capital Account	Tax Basis in Tax-Option Corporate Form: Capital Account	Tax Basis in Tax-Option Corporate Form: Loan Account	Taxable Income: Actual Partnership Form	Taxable Income: Tax Option Corporate Form
Fox's share of 1959 income:						
Corporate ordinary income	$ 195.88		$ 195.88			$ 195.88
Bonus paid at end of year	3,400.00		3,400.00			3,400.00
Salary	7,200.00					7,200.00
Partnership income	$10,795.88	$10,795.88			$10,795.88	
Totals		$25,044.29	$19,985.27	-0-	$10,795.88	$10,795.88
Withdrawals:						
Balance of loan	$ 1,349.70			$1,349.70		
Div. from cur. income	2,050.30		2,050.30			
Total actual bonus	$ 3,400.00					
Salary	7,200.00					
Partnership withdrawals	$10,600.00	10,600.00				
Excess of repayment of loan basis (0) is income				(1,349.70)		1,349.70
Balances December 31, 1959		$14,444.29	$17,934.97	-0-	$10,795.88	$12,145.58
Total taxable income for all years					$41,987.77	$45,478.45
Diff. between both bases & income is the excess of net opr. losses over bases of the cap. acct.:						
1954	$ 2,385.60					
1955	1,105.08					
Amount taxed twice	$ 3,490.68	3,490.68			3,490.68	
		$17,934.97	$17,934.97		$45,478.45	$45,478.45

a/Footnotes a, b, and d of Table 25 are equally applicable to this table. Similarly, footnote 1 on page 129 applies equally to the discussion of Table 26.

leaving a basis in his stock of $106.94, at the end of 1954. Field made an additional capital investment in 1955 of $1,596.85 so that even when the 1955 net operating loss of $1,105.08 is deducted he still had a balance in the basis of his capital account. Profits were earned thereafter so that the basis of his stock increased each year.

When Fox's situation, as reflected in Table 26, is compared with Field's basis, a problem is revealed. Since Fox invested only $857.83 in the first year, the basis of his account would have a negative balance if his share of the net operating loss of $3,043.43 were deducted. Instead of allowing negative bases, Subchapter S provides that the basis of a stockholder's capital account shall not be reduced below zero.[1] The excess of the net operating loss over the basis of the capital account is then used to reduce the basis of any indebtedness of the corporation to the stockholder.[2] Thus, $657.83 of the 1954 net operating loss is deducted from the basis of Fox's capital account in Table 26 and the remaining $2,385.60 is deducted from the basis of his loan account.[3] Similarly, the 1955 net operating loss of $1,105.08 must all be deducted from the basis of his loan account, because the capital account is already at zero. The net result is that Fox had loaned the corporation a net of $5,800 during the two-year period, but the loan account had a basis of $2,509.32. These two amounts consisted of:

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[1] Sec. 1376(b)(1)

[2] Code Sec. 1376(b)(2)

[3] Remember that this loan account is, as was specified on page 129, the excess of the assumed salary of $3,600 over actual withdrawals in the partnership. Obviously, if no salary were assumed, there would be no net operating loss and the problem would not arise. However, it is believed that a salary of this amount would have been set up if the corporate form had been used. Certainly, the typical situation would call for a salary and $300 a month is nominal enough. The result would be correspondingly greater if a larger salary were assumed.

Amount loaned to corporation:		
1954 excess of assumed salary over actual withdrawals:		
Assumed salary	$3,600.00	
Actual withdrawals (charged against capital account before end of year)	-0-	$3,600.00
1955 excess of assumed salary over actual withdrawals:		
Assumed salary	$3,600.00	
Actual withdrawals	1,200.00	2,400.00
Amount due from corporation		$6,000.00
Portion of net operating losses charged against basis of loan:		
1954	$2,385.60	
1955	1,105.08	3,490.68
Basis of loan account		$2,509.32

The amounts in the preceding tabulation are all taken directly from Table 26, but are set forth here to emphasize that the differences which show up in the third page of Table 26 all stem from the $3,490.68 of net operating losses which are deducted from the basis of the loan account. This $3,490.68 is the exact difference between the total income taxed to Fox as a partnership and as a tax-option corporation (the two right-hand columns of Table 26). It is also the exact difference between the basis of his capital account and the balance of his partnership capital account.

Summary.--The net result is that Fox would have paid tax on $3,490.68 more income if the firm had been organized as a tax-option corporation than he did under the partnership form actually used. On the other hand, his capital account would have a $3,290.68 higher basis than he has actually invested in the account.

Cause.--The additional taxable income in the tax-option form arose when the loan was repaid in 1958 and 1959. It seems strange that repayment of a loan is income, but that is the interpretation which must be given to a literal reading of the Code and regulations. Both the Code and the regulations specifically authorize and require the upward adjustment of the basis of stock for such things as undistributed taxable income which is actually reported on the stockholder's

return.[1] Both are silent, by contrast, concerning the upward adjustment of the basis for debt which has been adjusted downward by net operating losses. So, if the debt is later repaid, as was the loan from Fox, the payment is taxable income.[2] That income may be taxed at ordinary rates or at capital gains rates, depending upon circumstances. If the loans are "bonds, debentures, notes, or certificates or other evidences of indebtedness," the repayment probably would be taxed at capital gains rates if the repayment meets the other requirements of Section 1232 of the Code. If not, the income would be taxed at ordinary rates. So, if Fox's loan of his salary back to the corporation were not covered by formal notes, the repayment of the loan would be taxed at ordinary rates.[3]

Opinion.--The reader of this report should bear in mind that the treatment in Table 26 is purely the interpretation of the authors of this report. Their opinion is based on a careful study of all of the material on the subject which came to their attention, but is still only an opinion. The whole area of Subchapter S is so new that the statute has not been tried in the courts. Decisions may force different interpretations than presented here.

Situation When Losses Are Larger Than Both Capital and Loans

Note that the basis of Fox's debt account did not get down to zero. Had this happened, part of the net operating loss would have been lost forever, and would have done no tax good. This situation is different than in a partnership where deduction can be obtained when the basis is brought back to a positive figure.

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[1] Code Sec. 1376; Reg. Sec. 1.1376.

[2] Numerous authors have pointed this out. For example, see the comment by Leonard Sarner in "The 'Pseudo Corporation'," 27 Tennessee Law Review (Winter, 1960) at p. 237; Chapin, "Subchapter S and Capitalization," 13 Vanderbilt Law Review (December, 1959) p. 192; Kalupa, "Remedy of Defects in Subchapter S Asked by ABA Taxation Committee," 11 Journal of Taxation (October, 1959) p. 198.

[3] See the citations in the preceding footnotes for other writers' expressions of this idea.

Furthermore, a partner is allocated part of all of the indebtedness of the firm, so it is rare that a partner has losses denied. These aspects of the difference between a partnership and a Subchapter S tax-option corporation are explored in detail in Chapter VII.[1]

Situation if Excess of Salary Over Actual Partnership Withdrawals Are Not Loaned Back

The computations in Tables 25 and 26 are based on the assumption that a salary of $3,600 a year was paid to each of the owners, and that the difference between that assumed salary and the actual withdrawals which were made in the partnership were loaned back to the corporation. Further understanding of the application of Subchapter S when there are losses are revealed if it is assumed that the salaries were not loaned back. Table 27 summarizes a study of Fox's basis in his capital stock, and the income taxed to him, if the salary were not loaned back to the corporation. The "loan" column is retained even though there are no entries in that column so that comparison with Table 26 will be easier.

In order to keep the illustration as realistic as possible, it is assumed that no dividends were paid until the actual withdrawals in the partnership equal the salary. After that point is reached, partnership withdrawals are treated as distributions of current income. The effect of this is that the net investment in the firm is the same as in the actual firm by the end of 1959.

The rather surprising result reflected in Table 27 is that by the end of 1959 the basis of Fox's capital and the amount of income taxed to Fox is the same as in Table 26. In both instances, the basis of the capital account is $3,490.68 higher than the partnership capital account and Fox has had to pay tax on $3,490.68 more income than he did in the actual partnership. Note, however, that this is not true until the actual withdrawals and the assumed salary are the same. For example, at the end of 1957 the difference in the basis of the capital account in the tax-option

1/See footnote 1 on page 129.

TABLE 27
FIRM F
COMPARISON OF BASIS OF INVESTMENT IN TAX OPTION CORPORATION WITH ACTUAL PARTNERSHIP ACCOUNT, ASSUMING SALARY IS NOT LOANED BACK TO CORPORATION
New Owner--Roy Fox

		Actual Partnership Capital Account	Tax Basis in Tax-Option Corporate Form: Capital Account	Tax Basis in Tax-Option Corporate Form: Loan Account	Taxable Income: Actual Partnership Form	Taxable Income: Tax Option Corporate Form
Balances March, 1954		-0-				
Investment during 1954		$ 857.83	$ 857.83			
Withdrawals during 1954 a/		200.00	200.00			
Bal. before div. of 1954 profit		$ 657.83	$ 657.83			
Fox's share of 1954 profit:						
Per partnership books	$ 556.57	556.57			$ 556.57	
Assumed salary	3,600.00					$ 3,600.00
Corp. net operating loss	$(3,043.43)		(657.83)			(657.83)
					$ 556.57	$ 2,942.17
Balances December 31, 1954		$ 1,214.40	-0-			
Fox's share of 1955 profit:						
Per partnership books	$ 2,494.92	2,494.92			$ 2,494.92	
Assumed salary	3,600.00					$ 3,600.00
Corp. net operating loss	$(1,105.08)					-0-
Totals		$ 3,709.32	-0-		$ 2,494.92	$ 3,600.00
Withdrawals during 1955		1,200.00	-0-			
Balances December 31, 1955		$ 2,509.32	-0-			
Fox's share of 1956 profit:						
Per partnership books	$ 6,086.05	6,086.05			$ 6,086.05	
Assumed salary	3,600.00					$ 3,600.00
Corp. undist. taxable inc.	$ 2,486.05		$ 2,486.05			2,486.05
Totals		$ 8,595.37	$ 2,486.05		$ 6,086.05	$ 6,086.05
Withdrawals during 1956		1,700.00	-0- b/			
Balances December 31, 1956		$ 6,895.37	$ 2,486.05			
Fox's share of 1957 profit:						
Per partnership books	$ 9,023.81	9,023.81			$ 9,023.81	
Assumed salary	3,600.00					$ 3,600.00
Corp. undist. taxable inc.	$ 5,423.81		5,423.81			5,423.81
Totals		$15,919.18	$ 7,909.86		$ 9,023.81	$ 9,023.81
Withdrawals in 1957		3,736.31	-0- b/			

TABLE 27
FIRM F

		Actual Partnership Capital Account	Tax Basis in Tax-Option Corporate Form: Capital Account	Tax Basis in Tax-Option Corporate Form: Loan Account	Taxable Income: Actual Partnership Form	Taxable Income: Tax Option Corporate Form
Balances December 31, 1957		$12,182.87	$ 7,909.86			
Investment during 1958		115.49	115.49			
Fox's share of 1958 profit:						
Per partnership books:						
Ordinary income	$12,722.38					
Long-term capital gain	308.16					
Total per tax return	$13,030.54				$13,030.54	
Unallowable deductions	1,066.50					$ 1,066.50
Net income per books	$11,964.04	11,964.04				
Assumed salary	3,600.00					3,600.00
Corp. undist. taxable inc.	$ 8,364.04		8,364.04			8,364.04
Totals		$24,262.40	$16,389.39		$13,030.54	$13,030.54
Withdrawals in 1958		10,013.99	-0-			
Balances December 31, 1958		$14,248.41	$16,389.39			
Fox's share of 1959 income:						
Corp. ordinary income	$ 195.88					$ 195.88
Bonus paid at end of year	3,400.00					3,400.00
Corp. inc. assuming no bonus	$ 3,595.88		3,595.88			
Salary	7,200.00					7,200.00
Partnership income	$10,795.88	10,795.88			10,795.88	
Totals		$25,044.29	$19,985.27		$10,795.88	$10,795.88
Withdrawals:						
Bal. of excess of assumed salary over actual withdrawals to 12-31-58	$ 1,349.70[b/]					
Div. from cur. income	2,050.30		2,050.30			
Total actual bonus	$ 3,400.00					
Salary	7,200.00					
	$10,600.00	$10,600.00				
Balances December 31, 1959 (forward)		$14,444.29	$17,934.97			

TABLE 27
FIRM F

		Actual Partnership Capital Account	Tax Basis in Tax-Option Corporate Form: Capital Account	Tax Basis in Tax-Option Corporate Form: Loan Account	Taxable Income: Actual Partnership Form	Taxable Income: Tax Option Corporate Form
Balances December 31, 1959		$14,444.29	$17,934.97			
Total tax. inc. for all years					$41,987.77	$45,478.45
Diff. bet. both bases and inc. is the excess of net opr. losses over bases of the cap. acct.:						
1954	$ 2,385.60					
1955	1,105.08					
Total	$ 3,490.68	3,490.68			3,490.68	
		$17,934.97	$17,934.97		$45,478.45	$45,478.45

a/Withdrawals are subtracted from investment before application of operating results in 1954 in order to comply with the provision in Reg. Sec. 1.1376 that the bases reduction is as of the last day of the year. The balance is high enough in ensuing years that it makes no difference if withdrawals (dividends) are deducted before or after operating results.

b/It is assumed that no dividends were paid until the assumed salary was equal to actual withdrawals from the partnership.

form and the partnership capital account is:

Partnership capital account	$12,182.87
Basis of capital stock in tax-option corporation	7,909.86
Difference	$ 4,273.01

At this time, the basis of the capital stock account is less than the actual partnership capital account. By the end of 1959, the basis of Fox's capital stock account is $3,490.68 more than the actual capital account. Thus, if Fox had sold his stock in the corporation at the end of 1957 he would have had $7,763.69 more capital gain than if he sells it after 1959 just from the difference between the basis of his stock and the actual investment in the account (this is the gain from adjustment of basis only--the actual selling price would determine the rest of the gain or loss). This consists of:

Basis below actual investment at end of 1957	$4,273.01
Basis above actual investment at end of 1959	3,490.68
Total	$7,763.69

In addition to this capital gain, do not forget that Fox paid tax on an additional $3,490.68 of ordinary income over the tax paid on the partnership form.

By contrast, if Fox sold his stock at the end of 1959, he would have to pay tax on the same amount as if the firm were a partnership. However, the amount taxed as ordinary income and as capital gain would be different:

Extra ordinary income in 1954 and 1955	$3,490.68
Less capital gain on sale of stock	3,490.68
Difference in total amount taxed	$ -0-

If Fox is in the 26% tax bracket this would mean $453.79 extra tax by virtue of having been organized as a tax-option corporation instead of a partnership:

Tax on $3,490.68 ordinary income in 1954 and 1955	$907.58
Reduction of capital gains tax on sale of stock-- 50% of $3,490.68 @ 26%	453.79
Extra tax	$453.79

However, do not forget that Fox does not intend to sell his stock. So, the practic result is that he would have paid $907.58 more tax in the tax-option form than he

would have in the partnership form. Some day he may get some of it back if he sells his stock.

SUMMARY AND CONCLUSIONS

Much of the study of Firm F in this chapter has been devoted to the unusual rather than to the typical. Yet, several conclusions of wide applicability can be drawn from these somewhat unusual circumstances.

The comparison of tax under alternative forms of organization reflected the unusual result that tax in the tax-option corporate form was higher than in the partnership form. This occurred because Fox's investment was less than his share of the net operating loss. The Code does not allow him to deduct losses in excess of the basis of his investment in the firm.[1/]

The analysis of special factors pursued these losses to determine why they are not deductible. Detailed applications of the "basis" provisions of Subchapter S were traced to their effect on the deductibility of these losses. Field had enough capital that his share of losses were never greater than his investment. The rules spelled out in the Code worked out simply and logically for him.

When similar comparisons were made for Fox's capital accounts the results were illogical and unfair. Fox would have paid considerably more tax if the firm had been operated as a tax-option corporation, but would have a basis in his stock which is higher than his actual investment. That higher basis would allow him to recover some of the excess tax when, and if, he ever sells the stock.

The basic computations assume that the excess of the corporate salaries over actual withdrawals in the partnership form were loaned back to the corporation. A second set of computations was made for Fox in which it is assumed that the

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[1/] Investment here meaning both stock and loans.

excess was not loaned back, but that no dividends were paid until the salary and partnership loan accounts were equal. The tax results were even worse here than in the principal computations, especially during those years before the salary and withdrawal accounts were equalized.

The analyses in this chapter demonstrate conclusively that the provisions of Subchapter S which allow stockholders in tax-option corporations to deduct their share of the net operating losses of their firm are sound and logical in the usual situation. However, these same provisions become extremely unfair and unjust when operating losses are larger than any one owner's basis in his capital accounts. Therefore, the tax-option corporate form should be avoided whenever one or more of the owners have contributed only small amounts of capital and operating losses are a possibility.

This chapter provides a demonstration of how difficult it is for Congress to enact a law which contains specific rules and still is applicable to the many divergent situations which are inherent in all business. The goal of Subchapter S, as discussed on page 2 of Chapter I, is without question sound and highly desirable. Yet, specific rules which were written into the law with certain typical relationships in mind create serious and unforeseen hardships under other conditions The provision which ties the deductibility of net operating losses to a stockholder' basis in his capital and loan accounts is one of those provisions. It is no more important than many other provisions, but was analyzed in this chapter to demonstrate the fact that the "traps" in these provisions are difficult to ferret out, but are nonetheless present in the law. The only way the businessman can find out if he might be caught by one of them is for him, or his professional tax advisers, to make detailed and careful projections of his tax under <u>all</u> likely possibilities before deciding to elect the tax-option treatment. The next two case studies demonstrate the type of computations which have to be made.

CHAPTER IX--FIRM G

EFFECT OF OUTSIDE INCOME
Special Analysis: Projection of Future Taxes as an Aid in Choosing Form of Organization

Many writers have pointed out that a proprietor often makes a key employee a part owner of his business in order to retain that employee and to add an incentive or reward for extraordinary effort.

Another reason for taking an employee into ownership may be that the proprietor can foresee an expansion or a new line of activity in which he can participate by starting the employee in business. Arnold Gage did this for Neal Green. Instead of taking Green into ownership of his principal business, a new venture was started as a partnership in which Green had a half interest. This new venture was related to Gage's business and represented an expansion into a new line. This new line has since become more important than the original business.

In addition to providing an example of the formation of a new venture out of part of a business, this case study highlights one of the most important features of tax planning--that <u>differences in either the amount or type of outside income of the owners creates serious conflicts in tax planning goals</u>.

Much of this chapter is devoted to a summary of the projection of future taxes which Firm G would have to pay under a wide range of possible income levels. These projections were requested by the firm in October, 1960, when it appeared that the firm was entering a period of rapid growth. The projections are summarized into four steps: (1) a comparison of 1960 taxes at different levels of income during the last three months of the year, (2) a comparison of future years' taxes at several levels of income under alternative forms of organization, (3) some unusual factors which were brought to light by the computations, and (4) a demonstration of how formation of a tax-option corporation could defer several thousand dollars of tax and so ease the pressure on working capital.

HISTORY OF THE FIRM

General

Green had been employed as a salesman for Gage for several years. He continued in that position and also became manager of the new venture. As can be seen from the balance sheets in Table 28, the capital investment was small. It consisted of an equal contribution by each for the down payment on the first inventory item. Insofar as possible, the firm was financed with borrowed funds which were made possible by the credit standing of Gage. Additional capital contributions by the partners were made only when the venture had to have funds to pay pressing bills.

While the product is a manufactured item, all of this manufacturing is sublet to other producers. So, there is no investment in plant and equipment. The firm acts as a coordinator and as a marketing organization, a type of operation especially adapted to small businesses, but often overlooked when a businessman or group of businessmen are looking for small business opportunities.

Green takes primary responsibility for management of the venture and devotes most of his time to it. Gage acts as general adviser and provides office and clerical facilities and help. During the first year of operations, James paid for all general and administrative expenses by having them performed by his regular office staff, but Firm G now has one regular employee of its own and pays bills which are directly applicable to it. Gage's original business still pays many of the indirect office costs but this is regarded as a partial offset to the larger amount of time devoted to the concern by Green.

Green still does some sales work for Gage's original business and is paid the same commission rate as was in effect before Firm G was started. However, these commissions have dropped from $13,500 in 1958 when Firm G was being started, to $6,700 in 1959 and about $4,000 in the first nine months of 1960.

Orders were so good during the third quarter of 1960 that the partners anticipate high profits in the last quarter of the year. While they recognize that

profits mean high Federal income taxes, they face a serious working capital problem, so want to defer payment of these taxes as long as possible. They called a meeting with their certified public accountants and attorneys right after the September financial statements were prepared. Most of this chapter is devoted to summaries of the various computations and comparisons which were made as a result of that conference.

Financial History

Before looking at these comparisons, however, it is desirable to know more of the history and financial position of the firm. The easiest way to report this history is by the use of financial statements (the tool businessmen have developed to tell the financial story of business). Table 28 starts telling the story by showing the financial position at the inception of the venture and at the end of

TABLE 28
FIRM G
CONDENSED, COMPARATIVE BALANCE SHEETS

	Jan. 1958	Dec. 31 1958	Dec. 31 1959	Sept. 30 1960
Current Assets:				
Cash	$500	$ 2,300	$ 3,300	$ (100)
Receivables			4,900	15,300
Inventories (primarily work-in-process)		14,000	123,400	156,900
Total current assets		$16,300	$131,600	$172,100
Other Assets		300	1,100	8,200
Total assets	$500	$16,600	$132,700	$180,300
Current Liabilities:				
Accounts payable			$ 57,800	$ 32,000
Notes payable		$10,600	50,000	85,700
Customers' deposits			7,000	42,800
Loan from partner			3,000	
Total current liabilities		$10,600	$117,800	$160,500
Owners' Equity	$500	6,000	14,900	19,800
Total liabilities and equity	$500	$16,600	$132,700	$180,300

each year thereafter, as well as at September 30, 1960. The changes reflected in these balance sheets summarize the story of the expansion of the firm. Amounts are rounded to the nearest hundred dollars for ease of comparison.

The story of how sales and profits have brought about this growth is told in the earnings statements in Table 29.

TABLE 29
FIRM G
CONDENSED, COMPARATIVE EARNINGS STATEMENTS

	Year Ended Dec., 1958	Year Ended Dec., 1959	Nine Months Ended Sept., 1960
Sales	$57,500	$172,300	$267,100
Cost of sales	48,400	155,800	252,000
Gross Profit	$ 9,100	$ 16,500	$ 15,100
Operating expenses		800	2,200
Net operating profit	$ 9,100	$ 15,700	$ 12,900
Other income and expense		1,100	1,500
Net profit	$ 9,100	$ 16,800	$ 14,400

As was noted earlier, the firm has been financed almost entirely with credit, but the partners have made small capital contributions from time to time. They have attempted to keep their capital accounts as nearly equal as possible. However, financial pressure has not always allowed this to be done. In some instances, Gage has made temporary loans to the partnership. These have been repaid as soon as possible, with interest.[1/]

At first, withdrawals were made quite regularly, but the demands on working capital caused by increased sales eventually made this impossible. However, when one partner has had to withdraw funds to meet personal obligations, the other partner has made a similar withdrawal as soon as cash was available, or the first partner has replaced the withdrawal when he could. The way in which these contributions and withdrawals have been handled is summarized in Table 30.

[1/]As can be seen in Table 28, one of these loans was outstanding over the end of 1959.

TABLE 30
FIRM G
SUMMARY OF PARTNERS' CAPITAL ACCOUNTS

	Year Ended Dec. 31, 1958		Year Ended Dec. 31, 1959		Nine Mo. Ended Sept. 30, 1960	
	Gage	Green	Gage	Green	Gage	Green
Beginning balance	-0-	-0-	$ 3,000	$ 3,000	$ 7,700	$ 7,200
Contributions	$3,000	$3,000	5,000	5,000		
Profit	4,550	4,550	8,400	8,400	7,200	7,200
	$7,550	$7,550	$16,400	$16,400	$14,900	$14,400
Withdrawals	4,550	4,550	8,700	9,200	4,600	4,900
Ending balance	$3,000	$3,000	$ 7,700	$ 7,200	$10,300	$ 9,500
Combined capital accounts as shown in Table 28	$6,000		$14,900		$19,800	

TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

Taxes which would have been paid under alternative forms of organization are summarized and compared with taxes actually paid in Table 31. Note that exactly the same tax would have been paid in the tax-option corporate form as was paid as a partnership, but that even with optimum tax planning the corporate tax is a little higher. With poor planning, the tax in the corporate form is considerably higher than in the partnership or tax-option corporate form. When the tax which will eventually have to be paid if the retained earnings are distributed as dividends is considered, the difference is even more pronounced.[1/]

[1/] It is extremely difficult to make an accurate estimate of the amount of tax which will result when the retained earnings are paid out as dividends because this tax is influenced by so many unknown factors. For example, if the tax brackets of the owners increase, the tax will increase. On the other hand, if the dividends were paid in a year in which the owners had losses from other sources, there might be no tax. Furthermore, the amount may never be withdrawn. If this happens, there should be an increased value in the stock for estate tax purposes when the owner dies, or the value of the stock should be higher in the case of sale of the stock during the owner's lifetime. Therefore, about all that can be done is to use an arbitrary rate, such as the 26% used in Table 31, or just observe that there will be additional tax sometime but the amount is uncertain.

TABLE 31
FIRM G
COMPARISON OF TAXES UNDER ALTERNATIVE FORMS OF ORGANIZATION

	Actual Partnership Transactions				Tax in Other Forms		
	Income				Tax-	Conventional Corp.	
	Partnership	Other Income	Total Income	Tax Paid	Option Corp.	Optimum[a] Planning	No[b] Planning
Dec. 31, 1958:							
Firm							$ 580
Gage	$ 4,567	$10,057	$14,624	$ 2,674	$ 2,674	$ 2,758	2,624
Green	4,567	9,053	13,620	2,257	2,257	2,355	2,208
Total	$ 9,134	$19,110	$28,244	$ 4,931	$ 4,931	$ 5,113	$ 5,412
Dec. 31, 1959:							
Firm						$ 124	$ 2,865
Gage	$ 8,375	$ 5,140	$13,515	$ 2,386	$ 2,386	2,254	2,184
Green	8,375	4,281	12,656	2,007	2,007	1,874	1,804
Total	$16,750	$ 9,421	$26,171	$ 4,393	$ 4,393	$ 4,252	$ 6,853
Sept. 30, 1960:							
Firm							$ 2,712
Gage	$ 7,221	$ 8,856	$16,077	$ 2,848	$ 2,848	$ 2,857	2,081
Green	7,221	4,000	11,221	1,641	1,641	1,646	1,039
Total	$14,443	$12,856	$27,298	$ 4,489	$ 4,489	$ 4,503	$ 5,832
TOTALS	$40,327	$41,387	$81,713	$13,813	$13,813	$13,868	$18,097

Additional Tax Which Would Have to Be Paid in Conventional Corporate Form When Retained Earnings Are Withdrawn Sometime in the Future:	
If taken as regular dividends when the owners are in the 26% bracket	$ 1,256
If taken as capital gains when the owners are in the 26% bracket	$ 628

[a]The "optimum tax planning" formula used in the computations on which this table is based included salaries of $400 a month to each owner during the first year of operations, $650 a month the second year, and $800 a month the last year. As has been emphasized many times in this report, this was easy to do now after the end of the year when it was possible to look back to see what the corporate income was and set the salary at a level which would just use it up. In practice, the salary has to be established at the beginning of the year when earnings are not known, so it is not usually possible to get the tax as close to the partnership tax as was done in this case study.

In making the computations, the salary of $400 a month in 1958 gave the corporation a net loss of $601.36. This was then used as a net operating loss carryover to 1959.

In view of the fact that both owners had been earning well over $10,000 a year before Firm G was formed and since they are devoting more and more time to the firm, there should be no question as to the reasonableness of the salaries used in this optimum tax planning formula. As was noted previously, the Internal Revenue Service has the power to treat part of purported salaries as dividends when those salaries are unreasonable--generally, more than the firm would pay a

The other income of the owners is a material factor in the above computations. Gage has a capital loss carryover of $1,000 during the first two years and $849 in 1960. There are no significant capital gain items in these years.

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stranger for the same services as were rendered by the officer-stockholders, or more than these persons could get doing similar work for a stranger.

[b]/The "no tax planning" formula used in the computations on which this table is based assumed a salary of $300 a month to each owner and dividends equal to the amount which had been withdrawn in the partnership. As has been emphasized repeatedly in this study, the result would be different if the assumptions were changed. However, as long as the individual tax brackets are not higher than the corporate bracket, tax in the corporate form will always be higher than in the partnership form, and much higher whenever dividends are paid.

An interesting point arises in the computations under the assumptions used. In both 1958 and 1959, withdrawals in the partnership form were higher than the profits. Part of these withdrawals were nothing more than withdrawal of temporary contributions, but under our assumptions here, all contributions are treated as purchase of stock and all withdrawals as salary or dividends. As a result, each owner withdrew $4.09 more in 1958 than his share of profits and several hundred dollars more in 1959. Since, under Code Section 316, a dividend cannot be taxed unless it is out of earnings, a dividend paid in excess of retained earnings and current profits is non-taxable. The tax computation for 1959 below illustrates the effect of this interpretation:

	Corporation	Gage	Green	Total
Net profit in partnership form	$16,749.16			$16,749.16
Officers' salaries	(7,200.00)	$ 3,600.00	$ 3,600.00	-0-
Dividends--withdrawals in partnership form less salary		5,005.51	5,505.51	10,511.02
Less dividends in excess of retained earnings		(230.93)	(730.93)	(961.86)
Dividends exclusion		(50.00)	(50.00)	(100.00)
Other ordinary income		6,139.80	4,280.94	10,420.74
Capital loss carry forward		(1,000.00)		(1,000.00)
Adjusted gross income	$ 9,549.16	$13,464.38	$12,605.52	$35,619.06
Standard deduction		(1,000.00)	(1,000.00)	
Exemptions		(1,800.00)	(2,400.00)	
Taxable income	$ 9,549.16	$10,664.38	$ 9,205.52	
Tentative tax	$ 2,864.75	$ 2,372.74	$ 1,993.44	
Dividends received credit		188.98	188.98	
Final tax	$ 2,864.75	$ 2,183.76	$ 1,804.46	$ 6,852.97

SPECIAL FACTOR ILLUSTRATED BY THIS CASE--
THE SEARCH FOR THE BEST FORM TO USE IN THE FUTURE

The special factors which are analyzed in this chapter concern the projection of future taxes which Firm G prepared in September, 1960, when it began to appear that a change in form of organization might be wise. This review is included in this report in order to emphasize that there is no easy way to decide which form is best for a particular firm. The only satisfactory method of finding that best form is for the members of the firm and their professional advisers to sit down and compute the tax under all of the alternatives. This is just plain hard work (but work which pays high dividends in sound results if carefully done).

Computation of 1960 Taxes

The first step which was taken was to compute the tax which will have to be paid for 1960 if no change is made in organizational form, using several assumptions as to earnings during the last three months of the year. These computations are summarized in Table 32.

Note that the accountants and attorneys[1/] were careful to compute the tax at profit levels both higher and lower than expected. Thus, although the firm expects profits during the last three months of 1960 to be as much as in the entire first nine months, the projection was made for two rates of profit which are less than this amount and also for two rates of profit which are larger than this estimate. This is essential if they are to understand the problem well enough to make an intelligent decision.

[1/] Gage has always retained a certified public accountant and an attorney who cooperate fully in tax matters. Since the accountant prepares periodic operating statements and works closely with Gage's bookkeeping staff, he has the income data under constant surveillance. He usually computes the tax which would tend to result from contemplated action then passes his computations to the attorney for double checking and for legal aspects. Similarly, when a tax problem arises out of legal matters, the attorney makes the computations and passes them to the accountant to be sure he has not overlooked anything which the accountant may know from his close association with the financial picture of the operation.

TABLE 32
FIRM G
TAXES WHICH WILL BE PAID
AT VARIOUS LEVELS OF PROFIT DURING THE LAST THREE MONTHS OF 1960

Assumed Profit of Firm G and Other Income of the Partners During the Last Three Months of 1960	Gage Adjust. Gross Income	Gage Tax	Gage Top Tax Rate	Green Adjust. Gross Income	Green Tax	Green Top Tax Rate	Total Combined Tax
None From Either Firm G or From Other Sources (Total Firm G income--$14,442.24)	$15,228	$2,848	30%	$11,221	$1,641	22%	$ 4,489
Same Rate of Profit in Firm G as in First Nine Months (Total Firm G income--$19,256.32)							
No other income in last three months	17,635	3,571	30	13,628	2,259	26	5,830
Other income earned at same rate as in first 9 months	20,578	4,528	34	14,961	2,606	26	7,134
Other income changed at same rate as Firm G income	20,578	4,528	34	14,961	2,606	26	7,134
Profit of Firm G Double Monthly Average Rate of the First 9 Months (Total Firm G income--$24,070.40)							
No other income in last three months	20,042	4,242	34	16,035	2,910	30	7,152
Other income earned at same rate as in first 9 months	22,994	5,354	38	17,369	3,311	30	8,665
Other income changed at same rate as Firm G income	25,946	6,476	38	18,701	3,710	30	10,186
Same Dollar Profit in Firm G as in the First 9 Months (Total Firm G income--$28,884.48)							
No other income in last three months	22,449	5,161	34	18,442	3,632	30	8,793
Other income earned at same rate as in first 9 months	25,401	6,268	38	19,776	4,048	34	10,316
Other income changed at same rate as Firm G income	31,305	8,757	47	22,442	4,954	34	13,711
Monthly Profit of Firm G 50% Over Monthly Profit of the First 9 Months (Total Firm G income--$36,105.60)							
No other income in last three months	26,059	6,518	38	22,053	4,822	34	11,340
Other income earned at same rate as in first 9 months	29,012	8,181	43	23,386	5,275	34	13,456
Other income changed at same rate as Firm G income	39,343	12,688	53	28,053	7,081	43	19,769
Monthly Profit of Firm G Double Monthly Profit of the First 9 Months (Total Firm G earnings--$43,326.72)							
No other income in last three months	29,670	8,034	43	25,663	6,140	38	14,174
Other income earned at same rate as in first 9 months	32,622	9,376	47	26,997	6,647	38	16,023
Other income changed at same rate as Firm G income	47,382	17,104	59	33,663	9,583	47	26,687

In addition to making projections at different levels of earnings of Firm G, each set of computations includes a projection at three levels of outside income. The middle computation in each set is the most likely level of outside income. In this middle computation, Gage's other income for the year is assumed to be $11,808.09 and Green's $5,333.33. James has the net capital loss carryover of $849.19 which was pointed out earlier, or his tax would be even higher.

This projection at three levels of outside earnings was especially significant to Firm G because it revealed that the comparative tax position of the two owners changes rapidly when outside income increases. Outside income could easily be more important than the income of the firm in selecting desirable tax alternatives.

Projected Taxes for Future Years

Gage and Green were impressed with the fact shown in Table 31 that the lowest tax on profits earned so far would be paid in the partnership form in which they are now organized. However, they were even more impressed with the rise which will take place in those taxes if the profits for the last three months of 1960 are high. This increase can be seen in Table 32. There were substantial losses on some orders early in 1960 as a new manufacturing process was adopted by the subcontractors, so it is entirely possible that dollar profits may be as high in these last three months as in the first nine. There is no reason to believe that other income will slacken, so the owners may very well be in the 38 and 34 per cent brackets indicated in the middle computation in Table 32. The tax brackets of 59 and 47 per cent shown in the last line of that table are possible. Even if they should have no additional income from outside sources (and this is unlikely) they could easily reach the 43 and 38 per cent brackets shown on the first line of the last set of computations in Table 32.[1/]

[1/]Remember, as was pointed out in Chapter II, this does not mean that they would pay 43 and 38 per cent of their income in tax. These rates are the tax on the last, or marginal, dollars earned only. Thus, note that when Gage's income is $47,382 and he is in the 59% bracket, his total tax is $17,104, which is a little less than 37% of his income.

At these earnings levels, Gage and Green thought it possible that formation of a corporation might lessen the tax burden since the first $25,000 of corporate income is taxed at 30 per cent. In order to answer this question, a series of computations similar to those summarized in Table 31, but covering the year 1961 under several possible levels of profit were made.[1/] These computations are summarized in Table 33.

One more column is included in Table 33 than in Table 31. This additional column reflects the tax which would be paid if the corporate form were used and $25,000 were left in that corporation. Gage and Green estimate that the profit of Firm G in 1961, and in the future, will probably be about double the 1960 profit. At this level, which is the second set of computations in Table 33, the lowest immediate tax would be paid in this corporate form with $25,000 of profit left in the firm but the remaining profit paid to the owners as salary and interest. However, there would be additional tax when these retained profits were distributed. As was pointed out in footnote 1 on page 151, it is impossible to predict what that tax will be.

Unusual Factors

One of the most serious mistakes commonly made in projections of future taxes is that of computing tax at only the anticipated level of earnings. Firm G did not make that mistake. So, Table 33 reflects projections at several levels of

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[1/] In all of these projections, the income from all sources other than Firm G is assumed to be earned at the same rate as was earned during the first nine months of 1960--that is, 12/9 of the income for the period January 1, 1960 to September 30, 1960. These assumed incomes are shown in the second column of Table 33 so that the reader will be reminded of their importance and amount.

Since Gage's assumed outside income of $11,808.09 is more than double Green's $5,333.33, and both are fairly sizable for a small firm, factors come to light which are not seen where the owners have no outside income as in Firm D in Chapter VI, or when both partners have nearly the same outside income as in Firm F in Chapter VIII.

TABLE 33
FIRM G
PROJECTION OF TAXES FOR FUTURE YEARS

	Actual Partnership Transactions				Tax in Alternative Forms			
	Income					Conventional Corporation		
Assumed Income of Firm G	Partner-ship	Other Income	Total Income	Tax Paid	Tax-Option Corp.	Optimum Planning	No Planning	$25,000 Profit Retained
Same as 1960:								
Firm						-0-	$ 2,177	
Gage	$ 9,628	$11,808	$21,436	$ 4,816	$ 4,816	$ 4,943	4,336	$ 4,816
Green	9,628	5,333	14,961	2,506	2,506	2,702	2,216	2,506
Total	$19,256	$17,141	$36,397	$ 7,322	$ 7,322	$ 7,645	$ 8,729	$ 7,322
Double 1960:								
Firm						$ 475	$ 8,286	$ 7,500
Gage	$19,256	$11,808	$31,064	$ 8,644	$ 8,644	8,490	6,468	3,849
Green	19,256	5,333	24,589	5,732	5,732	5,602	3,896	1,859
Total	$38,512	$17,141	$55,653	$14,376	$14,376	$14,567	$18,650	$13,208
Triple 1960:								
Firm						$ 1,630	$18,300	$ 7,500
Gage	$28,884	$11,808	$40,692	$13,403	$13,403	12,871	8,298	7,398
Green	28,884	5,333	34,217	9,844	9,844	9,363	5,347	4,708
Total	$57,768	$17,141	$74,909	$23,247	$23,247	$23,864	$31,945	$19,606
Quadruple 1960:								
Firm						$ 2,786	$28,313	$ 7,500
Gage	$38,512	$11,808	$50,320	$18,837	$18,837	17,858	10,325	11,910
Green	38,512	5,333	43,845	14,769	14,769	13,864	7,031	8,497
Total	$77,024	$17,141	$94,165	$33,606	$33,606	$34,508	$45,669	$27,907
None:								
Firm								
Gage	-0-	$11,808	$11,808	$ 1,942	$ 1,942	$ 3,722	$ 3,722	Not
Green	-0-	5,333	5,333	480	480	1,665	1,665	Applicabl
Total	-0-	$17,141	$17,141	$ 2,422	$ 2,422	$ 5,387	$ 5,387	
Loss Equal to 1960 Profit:								
Firm								
Gage	$(9,628)	$11,808	$ 2,180	-0-	$ 1,070	$ 3,722	$ 3,722	Not
Green	(9,628)	5,333	(4,295)	$ 1,108R	-0-	1,665	1,665	Applicabl
Total	($19,256)	$17,141	$(2,115)	$ 1,108R	$ 1,070	$ 5,387	$ 5,387	
Loss Double 1960 Profits:								
Firm								
Gage	($19,256)	$11,808	$(7,448)	$ 1,729R	$ 1,070	$ 3,722	$ 3,722	Not
Green	(19,256)	5,333	(13,923)	2,336R	-0-	1,665	1,665	Applicabl
Total	($38,512)	$17,141	($21,371)	$ 4,065R	$ 1,070	$ 5,387	$ 5,387	

R=Refund of tax paid in prior years.

earnings and, even more important, at loss situations.

As almost invariably happens when projections at several levels of both earnings and losses are made, some unusual factors are revealed which have a distinct bearing on the best choice of form of legal organization. Three of the unusual factors which came to light for Firm G are discussed in the next few paragraphs.

Best choice changes if there are losses.--One of the important facts revealed in the computations reflected in Table 33 is that the corporate form which would be best in the immediate future if Firm G operates at a substantial profit is the least desirable if there should be sizable losses. In the conventional corporate form, each of the owners would pay tax on his salary and the corporate loss would do no immediate tax good. In the tax-option corporate form, Gage would pay over $1,000 tax but Green would neither owe tax nor receive a refund. The same tax would be paid at both of the levels of loss used in Table 33. This is also true of the conventional corporate form, because the tax is paid by the individuals on their salaries.

In the partnership form, by contrast, both would receive refunds if the loss were double the 1960 profits, but only Green would receive a refund if the loss were equal to the 1960 profit. The reason for these differences between the two owners is that their outside income is different. This illustrates, again, the importance of each firm making its own detailed computations. A general rule could not reveal the effect of these individual differences.

If the large losses reflected in the last set of computations in Table 33 should occur, receipt of $4,065 of refunds in the partnership form as compared to payment of $5,387 of tax in the corporate form could well make the difference of whether the firm could survive or not.

Lost deductions.--The computations of taxes at loss situations which are

reflected in Table 33 provide an extraordinarily clear illustration of how some forms of organization can cause substantial deductions to be lost. If Firm G should incur the losses reflected at the bottom of that table, the following portions of the losses would do no immediate tax good.

	Partnership	Tax-option Corporation 1/	Conventional Corporation 1/
Loss equal to 1960 profit	-0-	$11,256	$31,256
Loss double 1960 profit	-0-	30,513	50,513

There is considerable difference in the nature of these "lost deductions" as between the three forms of organization, however. (The partnership form is included even though the amounts are zero for reasons which are set forth in the next paragraph). In the corporate form, these losses are available as net operating loss carry-overs to the next five years. So, if the corporation makes a profit during any of those five years, these losses in 1961 will not be lost in the long run. Even so, there is no assurance that these profits will arise.

In the partnership form, the amount of loss which each partner can deduct is limited by the basis of his capital interest.[2/] Since the capital accounts at the end of 1960 were only $10,000 each, it would at first appear that losses in excess of the capital accounts would be non-deductible. However, for the reasons discussed in Chapter VII, the basis of a partnership interest includes the partner's allocable share of liabilities of the partnership.[3/] Since Firm G has borrowed heavily, there is really no limit on the deductible losses within any likely range. If it were not for this peculiar provision, there would be "lost deductions" of $18,512.64 in the partnership form if Firm G sustained losses double the 1960 profits.

1/Not only does the loss sustained by the business become non-deductible, but the salaries paid to the owners increases this non-deductible loss. The salaries are assumed to be $6,000 each in these computations

As was noted in the introductory chapter to this study, the computations involve several pages of detail. Only the results are summarized in this report, but detailed computations are on file at the University of Nebraska.

2/ Code section 704(d)

3/ Code section 752.

If there were "lost deductions" in the partnership form, they could be used by the partners as soon as the basis of their capital interest was brought back to a positive figure. This could be done through contributions, loans to the partnership, borrowing by the partnership, or from earnings. This is a considerable advantage over the situation in a tax-option corporation.

The "lost deductions" in the tax-option corporate form are the most serious, because they cannot be availed of in future years. If a loss is not deductible in the year it occurs because it is larger than the basis of the capital account and the loans from the owners, that loss is forever denied as a deduction.[1/] Not only that, but if there had been any loans from the owners and the bases of these loans are reduced by the loss of the corporation, the owner has income when the loan is repaid. This income may be ordinary income rather than capital gain.

In a large loss situation, therefore, the tax-option corporate form is to be avoided unless the firm is extremely careful to be sure the capital accounts are large enough to cover any likely losses.

Advantage of proprietorship form.--In a sole proprietorship the amount of loss which is deductible is not limited by the amount of capital invested. So, Gage would find that there is a definite advantage in operating as a proprietorship rather than as a partnership if large losses should be incurred.

Since Green has little outside capital, Gage would have to stand both his own and Green's share of large losses. As a proprietor, he could deduct the entire loss. As a partner, payment of Green's share of the loss would probably be a bad debt. There is a question whether this type of bad debt can be deducted as a business bad debt or whether it must be treated as a non-business bad debt.[2/]

[1/]This provision is analyzed in detail in Chapter VIII.

[2/]See, for example, Robert W. DePuy, 14 TCM 268; CCH, Dec. 20, 944; P-H TCM 1955-81.

As a non-business bad debt, the deduction would have to be taken as a short-term capital loss.[1/] Unless there are offsetting capital gains, only $1,000 could be deducted each year for five years. The rest of the payment would be lost as a deduction.

This situation suggests that until profits are well established and while large losses are a possibility, a businessman in James' position should operate as a proprietorship.

Deferment of Tax With a Tax-Option Corporation.--One of the advantages claimed for the tax-option corporate form of organization is that a different fiscal year from that of the owners can be chosen, and thus transfer some of the income from a high income year to the next year. This would seem to fit Firm G's situation, so Gage and Green were enthused when the idea was first suggested. They estimate that income for the last three months of 1960 will be equal to the income for the first nine months. However, the demand for their product will likely stabilize at a lower level than the sales in these three months because the market for their product is a local one and is tied to the construction industry. So, deferring taxes into 1961 and later years seems desirable. They recognize that in the long run no tax will be saved unless their tax brackets drop, but deferring the tax would ease the present working capital strain considerably.

A projection was made of the effect of forming a tax-option corporation as of October 1 and electing two different fiscal years. These projections were made for both lower and higher earnings than were expected. The essential information from these computations is summarized in Table 34.[2/] The middle set of columns are the

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[1/] Code section 166(d).

[2/] It is assumed that the outside income of each will continue at the same rate as was earned during the first nine months of 1960. Thus, it is assumed that Gage's outside income is 12/9 of the $8,856.07 earned during those nine months, or $11,808.09 in each 12-month period. Similarly, it is assumed that Green's outside income is 12/9 of the $4,000.00 he earned in those nine months, or $5,333.33 in each 12-month period. This is the same assumption which is used in the projections in the preceding sections.

best estimates of the level of profits. The first and last sets of columns reflect the effect at lower and at higher levels of earnings, respectively.

The first could choose any of nine fiscal years starting with January 31 through September 30,[1/] but the two reflected in Table 34 are sufficient to show the effect. More detail would take attention from the essential points.[2/]

The first computation made by the accountants assumed a July 31 fiscal year. Using this year, a total of $10,310[3/] of tax could be deferred initially. The reason for this is that the income for the last three months of 1960 would not be taxed until the owners file their personal returns at the end of 1961. The 1961 returns of the owners would include the undistributed taxable income of the firm for the year during 1961. So, the 1961 returns include the income for the last three months of 1960, but in turn part of the income earned in 1961 is not taxed until 1962. The same thing happens in 1962 and each ensuing year. There is, therefore, a more or less permanent deferral of tax until the firm is either sold or dissolved.[4/]

In 1961 a result appears which Gage and Green and their advisers would likely not have been aware of if the detailed computations had not been made. Additional

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[1/]Legally they could choose a year ending in October, November, or December, but they would not defer much tax if one of these three months were chosen.

[2/]Many persons make the mistake of doing too much computing under too many assumptions. While it is essential, as has been emphasized throughout this chapter, that computations be made at several levels of income, too many can be nearly as bad as too few.

[3/]The illustrations in Table 34 ignore the fact that the salaries paid to the owners are taxed to them as paid. So, the actual deferral would probably not be quite as large as shown. This method was used in order to emphasize how the deferral happens unencumbered by modifying influences.

[4/]If losses are incurred in later years the deferred income is in effect taxed in the loss years. Thus, if 1962 were profitable but 1963 operations resulted in a loss, the 1962 income would be taxed in 1963 and the 1963 loss deferred to future years.

TABLE 34
FIRM G
TAXES WHICH WOULD BE DEFERRED
IF TAX-OPTION CORPORATION FORMED OCTOBER 1, 1960

Assumption	Income Last 3 Months of 1960 at Same Rate as in First 9 Months		Income Last 3 Months of 1960 at Same Rate as in First 9 Months		Income Last 3 Months of 1960 Double First 9 Months	
	Gage	Green	Gage	Green	Gage	Green
Assuming an Oct. 1-July 31 Fiscal Year						
1960:						
Income of Firm G--actual to Sept. 30	$7,221	$7,221	$ 7,221	$ 7,221	$ 7,221	$ 7,221
Tax which will be paid if present partnership is cont.	$4,528	$2,606	$ 6,268	$ 4,048	$ 9,376	$ 6,647
Tax which will be paid if tax-option corp. formed Oct. 1	3,734	1,980	3,734	1,980	3,734	1,980
Tax deferred	$ 794	$ 626	$ 2,534	$ 2,068	$ 5,643	$ 4,667
Aggregate deferral in 1960	$1,420		$4,602		$10,310	
1961:						
Income of Firm G:						
Last 3 months of 1960	$2,407	$2,407	$ 7,221	$ 7,221	$14,441	$14,441
First 7 months of 1961--7/12 of assumed income Jan. 1 to Dec. 31, 1960	5,616	5,616	8,425	8,425	12,637	12,637
Total for taxable year	$8,023	$8,023	$15,646	$15,646	$27,078	$27,078
Tax which would be paid if present partnership is cont.	$4,816	$2,606	$ 6,591	$ 4,014	$ 9,776	$ 6,647
Tax which will be paid if tax-option corp. with Oct. 1 to July 31 fiscal year is formed	4,270	2,189	7,081	4,456	12,446	8,996
Tax deferred (increased)	$ 546	$ 417	$ (490)	$ (442)	$(2,670)	$(2,349)
Aggregate deferral (increase) in 1961	$963		$(932)		$(5,019)	
Total Tax Deferred	$1,340	$1,043	$ 2,044	$ 1,624	$ 2,973	$ 2,318
	$2,383		$3,668		$5,291	
Assuming an Oct. 31--March 31 Fiscal Year						
1961:						
Same as for July 31 year as computed above	$ 794	$ 626	$ 2,534	$ 2,068	$ 5,643	$ 4,667
	$1,420		$4,602		$10,310	

TABLE 34
FIRM G

	Income Last 3 Months of 1960 at Same Rate as in First 9 Months		Income Last 3 Months of 1960 at Same Rate as in First 9 Months		Income Last 3 Months of 1960 Double First 9 Months	
	Gage	Green	Gage	Green	Gage	Green
1961:						
Income of Firm G:						
Last 3 months of 1960	$2,407	$2,407	$ 7,221	$ 7,221	$14,441	$14,441
First 3 months of 1961--3/12 of assumed income Jan. 1 to Dec. 31, 1960	2,407	2,407	3,610	3,610	5,417	5,417
Total for taxable year	$4,814	$4,814	$10,831	$10,831	$19,858	$19,858
Tax which will be paid if present partnership is cont.	$4,816	$2,606	$ 6,591	$ 4,014	$ 9,775	$ 6,447
Tax which will be paid if tax-option corp. with Oct. 1 to March 31 fiscal year is formed	3,265	1,404	5,226	2,950	8,840	5,782
Tax deferred	$1,531	$1,202	$ 1,365	$ 1,064	$ 935	$ 865
	$2,733		$2,429		$1,800	
Total Tax Deferred	$2,325	$1,828	$ 3,899	$ 3,132	$ 6,578	$ 5,532
	$4,153		$7,031		$12,110	

tax of $963 is deferred from 1961 to 1962 (over and above the tax deferred from 1960) when income for the last three months of 1960 is small. Additional tax of $932 is deferred when income in the last three months of 1960 is equal to the income of the first nine months. This is the situation estimated by the owners and comprises the second set of columns in Table 34. But when income is much higher than estimated, there is not an additional deferral in 1961, but rather, a using up of some of the $10,310 deferral from 1960, so that the net deferral is only $5,291. This happens because more income is taxed in 1961 than would be taxed in 1961 in the conventional partnership which they are now using.

This situation points out the importance of selecting the right fiscal year for the first taxable period. The time to close this first fiscal year would be much earlier than July 31 if income is high. To demonstrate this, the same computations were repeated for a fiscal year ending March 31. With this year, there would be an additional deferral of $1,800 in 1961 at the high profit level as compared to the using up of part of the 1960 deferral with a July 31 year. The net final deferment for the two final years is shown in Table 34 and is as follows:[1/]

	Fiscal Year Ending	
	July 31	March 31
If income for the last three months of 1960 is earned at the same rate as in the first nine months	$ 2,383	$ 4,153
If income for the last three months of 1960 is the same as was earned in the first nine months	3,668	7,031
If income for the last three months of 1960 is double the amount earned in the first nine months	5,291	12,110

This proves conclusively that there is a definite advantage for Firm G in forming a corporation and electing the partnership-like tax-option treatment afforded to it by Subchapter S of the Internal Revenue Code. At the lowest level

[1/]After 1961, there is no deferral because twelve months of income is included in each tax return of the owners. So, there is no need to continue the computations beyond the second year (1961).

of earnings used in these computations, over $4,000 of tax could be deferred. At the highest level, over $12,000 could be deferred.[1/]

This deferral is permanent for as long as the firm operates. That is, twelve months' income will be included in every year after the first. Several months' income will be deferred each year until the firm is dissolved or sold. So, the net effect is nearly as good as if these amounts of tax were saved in a firm which plans to stay in business for many years.

The cash which would otherwise have been used to pay taxes can remain in the firm as working capital.

SUMMARY AND CONCLUSIONS

The study of taxes which would have been paid under alternative forms of organization added another example of the fact that in most small businesses the lowest tax is obtained by use of either the partnership or tax-option corporate form of organization, but that tax in the corporate form can be nearly as low if careful tax planning is carried out.

Most of the analysis of Firm G was concerned with a summary of computations which were made as part of the search for the best form of legal organization for the future. The first step was to compute the tax which will result for 1960 if no change from the present partnership is made. Considerable emphasis was placed on computing this projection at several levels of earnings so that a complete picture can be seen. The next step was to project future taxes at several levels of earnings under alternative forms of organization. The computations for this study revealed that at the higher income levels, the lowest immediate tax would

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[1/]Remember, however, the modifications pointed out in footnote 3 on page 163. While $12,000 could be deferred the actual deferral would probably be less.

result from use of a conventional corporation with $25,000 of profit left in the corporation. However, when this $25,000 is eventually withdrawn (or sold with the firm) additional tax will have to be paid. So, in the long run, the partnership or tax-option corporate form will continue to give the lowest total tax even if income increases.

The detailed projection of future taxes revealed three unusual factors which would affect Firm G. One of these is that tax would have to be paid in the corporate form if large losses occur while refunds would be received by the owners through net operating loss carrybacks in the other forms. Another factor which was discussed and illustrated by Firm G is that substantial deductions can be lost in the tax-option and conventional corporate forms. While this can also happen in the partnership form, the provision which allows partnership obligations to be included in the basis of a partnership interest makes this less likely. Furthermore, a partnership loss which is not available one year becomes available in the future as soon as the basis of the capital interest is brought up to a positive balance. This is not true of the tax-option corporation. A deduction lost in that form is lost forever.

With these lost deductions in mind, Gage and Green asked if perhaps a sole proprietorship might be best if large losses are possible. Analysis proved that whenever one partner would stand all large losses because the other partner does not have the resources to contribute his share, the proprietorship form is definitely indicated.

The analysis was concluded by investigating the possibility of forming a tax-option corporation and electing a fiscal year. It was found that several thousand dollars of tax would be almost permanently deferred for Firm G if this is done. This deferment of tax would help relieve the firm's working capital squeeze and is recommended in spite of the lost deductions which could occur if there are large losses.

CHAPTER X--FIRM H

A LARGE FIRM WHICH SUSTAINED LOSSES
Special Analyses:
Net Operating Loss Deduction
Effect of Subchapter S Election on Social Security
Effect of Gifts of Stock to Children

One of the central themes of this study has been that there is no easy way for the businessman to find the tax effect of different forms of legal organization on his particular firm. General rules are helpful as broad guidelines, but before a sound decision can be reached, he or his tax advisers must actually compute the tax under each possibility.

The study of Firm H continues the pattern of the preceding chapter by summarizing projections which were made in the summer of 1960. The projections in this case were made to help the firm decide whether or not to elect the partnership-like tax option under Subchapter S. One of the factors involved is the effect on Social Security retirement payments.

Firm H is larger than most of the case study companies, so it affords an opportunity to observe the extent to which size influences the principles discussed in preceding chapters. The firm sustained large losses a few years ago, so particular emphasis is placed on the effect of the proper choice of form of organization when there are sizable losses in a comparatively large, well-established firm. Since the study of Firm E contained similar analyses for the small firm which was just being started, the two studies can be read together for a rather complete summary of the effect of losses.

HISTORY OF THE FIRM

General

<u>Departure from factual situation of prior studies</u>.--The study of Firm H departs

slightly from the factual situation to which this report has heretofore been restricted. Although the firm was originally organized as a proprietorship, as were all of the case study firms, the original proprietor transferred the business to his sons many years before the period covered by this study. They incorporated the business by a non-taxable exchange of the assets of the business for the capital stock of the corporation.

In contrast to the previous case studies, which involve the transfer of a business from a proprietorship to some other form of organization, this case starts with the corporation owned by the sons of the founder and inquires into the problems of transferring part of their interest in the corporation to their sons and nephews, the grandsons of the original proprietor. The grandsons have owned one qualifying share of capital stock apiece for several years.

Method of identifying each owner.--Since the relationships between the individuals is important, the two major owners are designated as "Owner A" and "Owner B," and the grandsons of the founder, all the sons of Owner A, are designated "Son A-1," "Son A-2," and "Son A-3."

Personal factors.--Both Owner A and Owner B are over sixty-five years of age, but are under seventy-two. They have been gradually turning more and more of the management of the firm over to the three young men. These three have worked for the firm for several years. Until quite recently, they have been paid the same salary or sales commission as other employees.

The salaries of the younger men have recently been increased substantially and they have been given most of the management responsibility for the regular operations of the firm.

The two major owners would now like to retire from operational responsibility but remain active in general supervision and policy formation. They have, at the same time, given considerable thought to the best method of bringing the three

young men into part ownership of the corporation. They have had several conferences with their attorneys and accountants. Upon recommendation of their accountant, they consented to this case study in order to get as much information as possible before making a decision.

Financial History

In order to summarize the financial history and position of the firm during recent years, condensed, comparative financial statements are included as Tables 35 and 36. Note that sales have increased substantially in the past two years and are now over $2 million. Operating profits have covered a wide range. They decreased steadily until a loss of nearly $70,000 was incurred in 1953. Most of this loss was occasioned by changes within the industry rather than by factors within the control of the firm. The firm had continued to operate much as they had for many years until the loss of 1953 forced them to take drastic action.

In 1953 the younger men in the family began to push for more modern methods of manufacture and for diversification into a related product which sells to an entirely different market in the same geographic area.

Although profits have been far from stable since 1953, a steady improvement has been made and prospects for the future are bright. Retained earnings, which, as can be seen in Table 35, dropped to a low of $31,400 in 1954 after having been greater than capital stock several years earlier are again climbing. Dividend payments were renewed in 1959, when nearly $10,500 was distributed.

Although no dividends were paid for several years prior to the 1959 fiscal year, each of the stockholders has worked in the firm and has drawn a regular salary. These salaries have been included in expense. The salaries paid to the owners reflect much of the story of the firm so are listed in detail in Table 37.

TABLE 35
FIRM H
CONDENSED, COMPARATIVE BALANCE SHEETS

	6-30-51	6-30-52	6-30-53	6-30-54	6-30-55	6-30-56	6-30-57	6-30-58	6-30-59	6-30-60
Current Assets	$167,800	$177,500	$148,800	$161,500	$139,900	$125,200	$132,900	$113,500	$126,800	$161,500
Property & Equip.:										
Cost	$286,200	$304,600	$307,000	$290,700	$324,800	$350,500	$361,200	$370,400	$400,800	$434,900
Accumulated depr.	162,800	150,900	163,000	147,900	159,200	168,800	184,900	205,100	224,100	246,900
Remaining cost	$123,400	$153,700	$144,000	$142,800	$165,600	$181,700	$176,300	$165,300	$176,700	$188,000
Other Assets	20,000	30,600	15,400	16,900	18,400	21,500	15,000	18,300		8,600
Total assets	$311,200	$361,800	$308,200	$321,200	$323,900	$328,400	$324,200	$297,100	$303,500	$358,100
Current Liabilities	$ 57,000	$129,000	$143,500	$146,400	$145,200	$139,700	$131,200	$120,700	$124,600	$120,400
Long-term Debt				11,600	12,600	11,700	10,000	8,000		37,000
Other Liabilities	6,000	3,000	1,900	2,800	2,400	2,600				
Stockholder's Equity:										
Capital stock	$129,000	$129,000	$129,000	$129,000	$129,000	$129,000	$129,000	$129,000	$129,000	$129,000
Retained earnings	119,200	100,800	33,800	31,400	34,700	45,400	54,000	39,400	49,900	71,700
Total equity	$248,200	$229,800	$162,800	$160,400	$163,700	$174,400	$183,000	$168,400	$178,900	$200,700
Total liabilities and equity	$311,200	$361,800	$308,200	$321,200	$323,900	$328,400	$324,200	$297,100	$303,500	$358,100

TABLE 36
FIRM H
CONDENSED, COMPARATIVE STATEMENT OF INCOME AND TAXES

	Y	e	a	r		E	n	d	e	d
	6-30-51	6-30-52	6-30-53	6-30-54	6-30-55	6-30-56	6-30-57	6-30-58	6-30-59	6-30-60
Sales	$1,583,900	$1,786,100	$1,499,700	$1,396,800	$1,626,700	$1,626,000	$1,824,600	$1,553,200	$1,937,200	$2,134,900
Cost	1,333,200	1,569,000	1,343,400	1,189,800	1,398,700	1,361,500	1,554,400	1,312,600	1,628,900	1,775,200
Gross prof.	$ 250,700	$ 217,100	$ 156,300	$ 207,000	$ 228,000	$ 264,500	$ 270,200	$ 240,600	$ 308,300	$ 359,700
Op. exp.	241,300	244,600	228,200	213,900	230,500	259,100	264,600	259,000	292,900	315,600
Net op. prof. (loss)	$ 9,400	$ (27,500)	$ (71,900)	$ (6,900)	$ (2,500)	$ 5,400	$ 5,600	$ (18,400)	$ 15,400	$ 44,100
Other	6,500	5,900	4,800	5,300	6,600	5,300	3,800	4,000	8,100	4,900
Tax. inc.	$ 15,900	$ (21,600)	$ (67,100)	$ (1,600)	$ 4,100	$ 10,700	$ 9,400	$ (14,400)	$ 23,500	$ 39,200
Net op. loss	(15,900)	21,600	67,100	1,600	(4,100)	(10,700)	(9,400)	14,400	(14,400)	
Final tax. income	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	$ 9,100	$ 39,200
Corp. Tax:										
Original:										
On ord. income	$ 3,700								$ 1,700	$ 14,900
On cap. gain	300								900	
Total	$ 4,000								$ 2,600	$ 14,900
Refund from N O L	4,000									
Net corp. tax	-0-								$ 2,600	$ 14,900
Ind. taxes:										
Owner A	$ 3,600	$ 3,900	$ 3,900	$ 2,400	$ 2,600	$ 2,600	$ 2,600	$ 2,600	4,000	3,100
Owner B	3,600	3,900	3,900	2,400	2,600	3,000	3,000	2,600	4,000	3,200
Son A-1	600	700	600	500	500	500	600	400	500	700
Son A-2	600	700	600	500	600	700	800	800	1,000	1,500
Son A-3	500	600	600	500	600	800	700	600	800	1,300
Total tax	$ 8,900	$ 9,800	$ 9,600	$ 6,300	$ 6,900	$ 7,600	$ 7,700	$ 7,000	$ 12,900	$ 24,700

TABLE 37
FIRM H
SALARIES PAID TO STOCKHOLDER-EMPLOYEES

Fiscal Year Ended in	Owner A	Owner B	Son A-1	Son A-2	Son A-3	Total
1951	$15,840	$15,840	$ 4,440	$ 4,200	$ 4,000a/	$44,320
1952	15,840	15,840	4,670	4,910	4,000a/	45,260
1953	15,840	15,840	4,506	4,980	4,000a/	45,166
1954	11,840	11,840	3,970	4,980	4,000a/	36,630
1955	12,840	12,840	3,840	5,480	4,640	39,640
1956	14,090	14,090	3,840	6,520	5,735	44,275
1957	14,040	14,040	4,440	7,032	6,144	45,696
1958	14,040	14,040	4,233	7,032	6,144	45,489
1959	14,040	14,040	4,750	8,032	7,144	48,006
1960	15,240	15,240	5,994	10,470	9,583	56,527

a/Estimated.

These salaries should be kept in mind as the earnings statements in Table 36 are studied.

TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

Taxes which would have been paid under alternative forms of organization are summarized and compared with taxes actually paid in Table 38. This table is the same as the corresponding table in the other case study chapters except for the last column. In 1960, Owner A gave 27 shares of stock to each of his sons. This last column reflects the tax which would have been paid if this gift had been made in 1950 instead of 1960 so that each of the sons would have owned 28 shares throughout the period. This becomes important in the analyses in the special problems section of this chapter. It also provides an opportunity to point out the tax saving which can be effected by spreading dividend income among family members. As was pointed out in the preceding section, no dividends were paid until 1959. In that year over $100 of tax would have been saved through having the sons

TABLE 38
FIRM H
COMPARISON OF TAXES UNDER ALTERNATIVE FORMS OF ORGANIZATION

Year	Actual Transactions			Tax in Alternative Forms			
					Tax Option	Conventional Corp.	
Ending In[a]	Sales	Total Net Income[b]	Total Tax Paid[c] [d]	Partnership	Corporation	Optimum Planning	With 1960 Share Dist.
1951	$ 1,583,900	$ 62,300	$ 8,900	$14,300	$14,300	$ 8,900	$ 8,900
1952	1,786,100	24,600	9,800	1,600	1,600	9,800	9,800
1953	1,499,700	(20,900)	9,600	800	800	9,600	9,600
1954	1,396,800	37,000	6,300	2,600	2,600	6,300	6,300
1955	1,626,700	45,700	6,900	7,900	7,900	6,900	6,900
1956	1,625,900	55,200	7,600	10,900	10,900	7,600	7,600
1957	1,824,600	57,100	7,700	10,700	10,700	7,700	7,700
1958	1,553,200	33,100	7,000	3,800	3,800	7,000	7,000
1959	1,937,200	73,500	12,800	14,900	14,900	10,600	12,700
1960	2,134,900	97,600	24,700	25,000	25,000	23,200	24,700
Total	$16,969,000	$465,200	$101,300	$92,500	$92,500	$97,600	$101,200

[a]It is assumed that individual income is the same as the salary to each in the corporate fiscal year even though fiscal years are different.

[b]Includes salary of individuals, assumed other income, and net business income _before net operating loss deduction_, but eliminates dividends from the business.

[c]All of the owners' returns were not available for all years, so tax is computed throughout on the assumption that each of the senior owners had $1,000 of other income, that the junior owners used the standard deduction. Corporate taxes are the exact amounts paid.

[d]The sons of Owner A owned only one share until 1960 and actual tax is computed on this basis. However, the other four computations are based on the 1960 ownership of 28 shares being owned by each son.

of Owner own 27 additional shares apiece. This factor is pursued further in the special analysis portion of this chapter.

The optimum tax planning column in Table 38 is the same as the conventional corporate columns until 1959 because the only withdrawals were in the form of salaries and there was no corporate tax during those years. There were losses of nearly $50,000 which did no tax good because the nine year spread of losses did not include enough high income years to use up all of the losses. This factor is also analyzed in more detail later in this chapter.

In 1959 and in 1960 the optimum tax planning column reflects the assumption that the dividends had been taken as salary instead of as dividends. This would have lowered tax $2,200 in 1959 and $1,500 in 1960. However, this so-called optimum tax planning could not have been used by the firm because the Internal Revenue Service would likely have determined that this additional amount was really a dividends.[1/] The firm was wise in handling the distributions as they did.

General conclusion.--Note that if the partnership-like tax option under Subchapter S had been available during the ten-year period covered by this study, the total tax paid by the firm and its owners combined would have been $92,500 rather than the $101,200 actually paid--a savings of $8,700. The losses of the firm would have offset the owners' salaries in the tax-option form and $48,600 which was lost as a deduction in the corporate form[2/] would have reduced the individual taxes.

The tax which would have been paid under the alternative plans varies greatly from year to year. Thus, in the loss year of 1953, the tax in the tax-option corporate or in the partnership form would have been only $800 for the entire family[3/] whereas they actually paid $9,600. Conversely, the entire family group would have

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1/ It would be hard to justify substantially higher salaries than were paid in prior years since the younger men are now assuming greater responsibility for management. The primary test is that amounts paid as salaries must not be more than a reasonable allowance for services actually rendered.

For further analysis and references see Graichen, "Reasonable Compensation," 17th N.Y.U. Institute (1958), p. 117.

2/ See table 39.

3/ This tax was paid by the sons of Owner A. Since they own only one share of stock apiece, their partnership or tax-option corporate interest was so small that their salary was greater than their share of the loss. Owners A and B obviously would have owed no tax in a large loss year if organized as a partnership or as a tax-option corporation (providing, of course, that the basis of their capital accounts is greater than the loss).

This factor of the sons' salaries being greater than their share of the loss also helps explain why the difference in tax between the conventional and the tax-option corporate forms was only a little over $8,700, even though over $50,000 of corporate losses did no tax good.

paid $10,900 in the tax-option corporate form in 1957 whereas the net operating loss carryover in the corporate form eliminated the corporate tax so that the entire group (family and corporation) paid only $7,600.

The net saving of $8,700 over the ten-year period makes the tax option election highly attractive in spite of the drawbacks which have been pointed out from time to time in this study.

SPECIAL FACTORS ILLUSTRATED BY THIS CASE

Effect of Net Operating Losses

Net operating losses were discussed in Chapter VII in connection with the losses incurred by Firm E. These comments should be reviewed before studying the effect of Firm H's losses in Table 39.

The income in the partnership and the tax-option forms reflected in Table 38 gives effect to the net operating loss carryovers and carrybacks for both the partnership and the tax-option forms.[1] The years to which the losses were carried are the same as the years reflected in Table 39 for the corporate form. However, several adjustments had to be given effect in the computation of individual taxes whereby losses are reduced by the capital gains deduction to arrive at the net operating loss and the net operating loss deductions.

Effect of Subchapter S Election on Social Security

The Problem

One of the problems involved in the taking of younger family members into ownership of a business is the maintenance of a reasonable income for the members who are retiring. One of the purposes of our social security system is to provide retirement income for those who have paid the premiums on this compulsory

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[1] No adjustments (see Chapter VII) were required in either the year of loss or the years to which income was carried.

TABLE 39
FIRM H
YEARS TO WHICH NET OPERATING LOSSES WERE CARRIED

	6-30-51	6-30-52	6-30-53	6-30-54	6-30-55	6-30-56	6-30-57	6-30-58	6-30-59	6-30-60
Income before carryover or carryback	$15,900	$(21,600)	$(67,100)	$(1,600)	$4,100	$10,700	$9,400	$(14,400)	$23,500	
1952 loss carried back to 1951	(15,900)	15,900								
Balance to carry forward		$ (5,700)								
Carried forward:										
1952 loss		5,700			(4,100)	(1,600)				
1953 loss			18,500			(9,100)	(9,400)			
1954 loss[a]										
1958 loss								14,400	(14,400)	
Income finally taxed	-0-	-0-			-0-	-0-	-0-	-0-	$ 9,100	
Losses which were "lost" as deductions			(48,600)	[a]						

[a] The 1954 loss was not carried forward because an error was inadvertently made on the 1954 return. Rather than file an amended return when the error was found (in the process of preparing the carryforward) the loss was not claimed in 1959. Actually the error was not quite as large as the $1,600 loss, but it was felt that the tax saving left did not justify the cost of revising the return. The government collected slightly more tax than was due so there can be no complaint.

insurance program.

Owners A and B of Firm H have paid into the Federal Old Age and Survivors Insurance program (generally captioned "Social Security") since it was started. If they continue to draw a salary from the corporation, they cannot draw retirement pay under the social security program until they are 72. If they retire and cease to draw a salary, they can draw retirement pay after age 65 even though they collect dividends from the corporation. This means, however, that their income tax will be high because of the double taxation of dividends.

The firm, therefore, faces a dilemma. The income of Owners A and B must be maintained. If the firm continues to pay them a salary, they must continue to work in the firm so that the salary is actually earned. Otherwise it will be treated as a dividend. If they retire, they can draw social security retirement benefits, but these payments are not sufficient to maintain the standard of living they have always maintained. So the firm would have to distribute dividends. But, double taxation would then consume much of the amount distributed.

<u>Tax-Option Election Might Provide Solution</u>

The partnership-like tax option under Subchapter S may provide an answer. The only stumbling block is the possibility that income of the corporation which is taxed to the owners might be treated as earnings from self-employment instead of being treated as dividends. If self-employment earnings are over $1,200 a year, part or all of social security retirement pay would be cancelled until the owners reach 72 years of age.

If, on the other hand, the undistributed taxable income does not have to be treated as earned income, Owners A and B can draw retirement payments from social security. They could still draw a reasonable director's fee without affecting

their social security.[1/] However, it is important that they not take part in the direct day-by-day operations of the corporation; but, instead, restrict their activities to those policy-making duties which are the responsibility of directors.[2/]

Law

So far as could be determined in the research for this paper, there has been no official ruling as to whether or not the undistributed taxable earnings of a tax-option corporation disqualify the owner of a corporation from social security. Every indication, however, is that they do not. The Revenue Service has ruled that the taxpayer does not have to pay self-employment tax on these earnings.[3/] Generally speaking, the only income which disqualifies a taxpayer for social security retirement payments are salary and self-employment income of over $1,200 a year.[4/]

The editors of the Wisconsin Law Review considered this problem in connection with farm corporations. They found few court decisions or official rulings, but did receive an informal, unofficial letter from the district manager of the Social

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[1/]The regulations under Sec. 210 of the Social Security Act as amended, specifically provide that: "A director of a corporation in his capacity as such is not an employee of the corporation."

[2/]The editors of Commerce Clearing House's Unemployment Insurance Reporter point out at ¶ 173: "If he (a director) performs services for the corporation other than those required by attendance at and participation in meetings of the board of directors, he may be an employee of the corporation."

[3/]Rev. Rul. 59-221. This ruling states in part: "Amounts which a stockholder is required to include in his gross income by reason of the provisions of Section 1373 of the Code should not be included in computing his net earnings from self-employment for Self-Employment Contributions Act purposes."

[4/]The editors of Commerce Clearing House's Unemployment Insurance Reporter discuss this at ¶ 274.01.

The Social Security Act, as amended, provides in Section 203(c)(1): "Deduction shall be made from any . . . insurance benefits based on the wages and self-employment income. . . ." Nothing is said about deductions from other sources.

Security district office in Madison and received informal answers at a state bar meeting which led them to conclude that undistributed taxable income of a Subchapter S tax-option corporation is not ordinarily earnings which would disqualify a person between the ages of 65 and 72 from receiving Federal Old Age retirement payments. However, they found that the Social Security Administration does not consider itself bound by the Revenue Ruling discussed above, but reserves the right to make their own determination. They intend to be guided by the facts of each individual case. One of the factors they will consider is whether or not the corporation was in existence before Subchapter S became available or before the owners reached the age of 65. They intend to examine the facts of each case and decide whether the undistributed taxable income is essentially similar to dividends or other excludible income, or whether it more closely resembles salaries or other earned income.[1/]

Practicing accountants and attorneys are apparently proceeding on the assumption that where an owner actually retires, the undistributed taxable income of his tax-option corporation will not disqualify him for social security. For example, the following comment appeared recently in one of the leading practitioner's journals.[2/]

> A sole proprietor or partner over 65 years of age frequently cannot collect social security benefits because of his self-employment income. If the business is incorporated and the election is made under Subchapter S and if the individual draws no salary from the corporation, he can not only save the self-employment tax but also become eligible for social security benefits.

Conclusion

Since Firm H has been incorporated for many years, and Owners A and B intend to retire from all operational responsibility and duties in the firm, the situation

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1/The letter is quoted in the July, 1960, Wisconsin Law Review, page 564.

2/Paul Mestern, "An Accountant's Approach to Subchapter S," 30 New York Certified Public Accountant, (March, 1960), 191.

seems clear-cut in every respect: Owners A and B can clearly draw Federal Old Age retirement benefits even though they have to pay income tax on some undistributed taxable income if Firm H elects the Subchapter S tax option. Based on this advice, they decided to elect the tax-option treatment for the year commencing July 1, 1960.

Safest Plan

Action.--With proper tax planning, the foregoing discussion of the effect of undistributed taxable income on social security retirement benefits is a moot question. All that needs to be done is to distribute all of the income as dividends each year. As was pointed out above, dividends do not disqualify them, and there would be no undistributed taxable income.

Firm H definitely plans to distribute all income each year even though some of these dividends have to be loaned back to the corporation.[1]

General advice.--This plan points again to the advice which has been stressed throughout this report to the effect that everything possible must be done to distribute all of the income of a tax-option corporation every year. This advice has been emphasized most strongly in connection with consideration of termination of the election and the fact that any profits which have been taxed to the stockholders nevertheless become fully taxable again when distributed after the election is no longer in effect.

Effect of Gifts of Stock to Sons

Procedure

As was noted on page 173, Owner A transferred 27 shares of stock to each of his sons during the 1960 year. Before the transfer was made, the value of each share was established. The 27 shares apiece are just sufficient to keep the gift

[1] They will have to be sure not to tie the dividends and the loan together. If they do, the Revenue Service might telescope them into one transaction for tax purposes.

within the gift tax exemption. If this program were continued over a period of years, Owner A's share of the corporation (or any desired portion of it) could be transferred to his children at no tax cost. By contrast, a substantial estate tax will have to be paid on his death if he retains his stock. This could even require that a substantial portion of the stock be sold to outsiders in order to raise the funds to pay the tax, although the relief provision discussed in Chapter II makes this less likely than it would have been prior to 1958.

Projection of Effect on Income Taxes

In order to visualize the income tax effect of these gifts, two sets of projections were made of tax for the next three years. Both sets of projections assume that the tax-option election will be continued. Both sets of projections assume that Owner A will give an additional 25 shares of stock to each son each year, but that Owner B makes no transfers of stock to his nephews. This permits a better comparison since Owner B's tax affects the situation with no gifts and Owner A's tax affects the situation with gifts. The first set of projections assumes that the income of the corporation will be $25 per share after total salaries to the three sons of $20,000. This is the best estimate the firm can make at this time.

As has been emphasized repeatedly throughout this study, projections should be made at other levels of earnings than those expected if intelligent tax planning decisions are to be made. So, the second set of projections assumes a corporate income of $50 a share. Both sets of projections are summarized in Table 40.

The computations in Table 40 ignore any outside income. This was done in order to pinpoint the effect of gifts of stock to the sons of Owner A. When Table 40 is compared with the right-hand column in Table 36, remember that the computations in Table 36 assume income of $1,000 each for Owners A and B. This makes about $250 difference in tax for each.

TABLE 40
FIRM H
PROJECTION OF TAXES IN TAX-OPTION CORPORATE FORM UNDER STOCK GIFTS TO SONS PLAN

	TOTAL	OWNER				
		A	B	A-1	A-2	A-3
Shares Owned:						
1960	1,290	561	645	28	28	28
1961	1,290	486	645	53	53	53
1962	1,290	411	645	78	78	78
Assuming that Corporate Income After Tax Is $25 Per Share:						
With 1960 Share Distribution:						
Salary	$20,000			$4,750	$ 8,100	$ 7,150
Dividends or undistributed taxable income of corp.	32,250	$14,025	$16,125	700	700	700
Total income	$52,250	$14,025	$16,125	$5,450	$ 8,800	$ 7,850
Tax	8,014	2,363	2,938	501	1,134	1,078
Income left after tax	$44,236	$11,662	$13,187	$4,949	$ 7,666	$ 6,772
With 1961 Share Distribution:						
Salary	$20,000			$4,750	$ 8,100	$ 7,150
Div. or undist. tax. inc.	32,250	$12,150	$16,125	1,325	1,325	1,325
Total income	$52,250	$12,150	$16,125	$6,075	$ 9,425	$ 8,475
Tax	7,886	1,875	2,938	613	1,258	1,202
Income left after tax	$44,364	$10,275	$13,187	$5,462	$ 8,167	$ 7,273
With 1962 Share Distribution:						
Salary	$20,000			$4,750	$ 8,100	$ 7,150
Div. or undist. tax. inc.	32,250	$10,275	$16,125	1,950	1,950	1,950
Total income	$52,250	$10,275	$16,125	$6,700	$10,050	$ 9,100
Tax	7,872	1,499	2,938	726	1,383	1,326
Income left after tax	$44,378	$ 8,776	$13,187	$5,974	$ 8,667	$ 7,774
Assuming that Corporate Income After Tax Is $50 Per Share:						
With 1960 Share Distribution:						
Salary	$20,000			$4,750	$ 8,100	$ 7,150
Div. or undist. tax. inc.	64,500	$28,050	$32,250	1,400	1,400	1,400
Total income	$84,500	$28,050	$32,250	$6,150	$ 9,500	$ 8,550
Tax	19,117	7,080	8,920	627	1,273	1,217
Income left after tax	$65,383	$20,970	$23,330	$5,523	$ 8,227	$ 7,333
With 1961 Share Distribution:						
Salary	$20,000			$4,750	$ 8,100	$ 7,150
Div. or undist. tax. inc.	64,500	$24,300	$32,250	2,650	2,650	2,650
Total income	$84,500	$24,300	$32,250	$7,400	$10,750	$ 9,800
Tax	18,400	5,622	8,920	857	1,537	1,464
Income left after tax	$66,100	$18,678	$23,330	$6,543	$ 9,213	$ 8,336
With 1962 Share Distribution:						
Salary	$20,000			$4,750	$ 8,100	$ 7,150
Div. or undist. tax. inc.	64,500	$20,550	$32,250	3,900	3,900	3,900
Total income	$84,500	$20,550	$32,250	$8,650	$12,000	$11,050
Tax	17,887	4,311	8,920	1,075	1,836	1,745
Income left after tax	$66,613	$16,239	$23,330	$7,575	$10,164	$ 9,305

<u>Conclusions Drawn From Projections</u>

Three general conclusions are apparent from a study of the projections summarized in Table 40. First, there would be some reduction in the total tax paid by the family group if additional stock is given to A's sons when corporate income is about $25 a share (about $50,000 a year) after salaries. However, the reduction becomes considerably larger as corporate income increases. Thus, the tax saved by increasing each son's stock from 28 shares to 78 shares is only $142 when corporate earnings are $25 a share, but $1,250 of tax is saved when corporate earnings are $50 a share. If corporate income climbs higher than $50 a share, significant tax savings could be effected by transferring stock to Owner A's sons. Conversely, if corporate income drops below $25 a share, little if any tax would be saved.

Should Owner B decide to also give or sell stock to A's sons, the tax effects reflected in Table 40 would be doubled.

The second conclusion can be drawn without making further projections. This concerns the amount of stock which should be transferred to Owners A-1, A-2, and A-3 to obtain the optimum tax saving. The answer lies in the earnings of the corporation. Enough stock should be transferred so as to keep the tax brackets of all of the stockholders as close together as possible. As corporate income rises, more shares should be transferred if tax is to be minimized.

The third conclusion is a warning. The dividends, and the undistributed taxable income of a tax-option corporation, must be divided according to the number of shares of stock held. So, as shares are transferred to Owners A-1, A-2, and A-3, income must be allocated to them which would otherwise go to the donor of the stock. For example, the net income of Owner A decreases from $11,662 after tax to $8,776 when corporate income is $25 a share and the sons have 78 shares apiece instead of 28. A similar comparison can be made for each assumption reflected in Table 40.

The division of income is, therefore, more important than the income tax savings which will result from transfer of stock to the younger men. While transfer of stock is wise from a tax standpoint, the tax savings are not significant enough to justify letting them take precedence over personal factors which might also be involved.

The important tax saving lies in the area of estate taxes. The size of the estate determines how significant these are. Since the stock can be given to each son at the rate of 25 shares a year with no gift tax, it would be wise to make these gifts regularly if the estate is large enough that there will be substantial estate taxes. Waiting too long might result in the gifts being set aside in computing estate taxes under the "contemplation of death" principle.

The same warning which was made in connection with income taxes must be sounded regarding estate taxes. Stock should be transferred to the younger men only if this transfer blends with the over-all estate plan. Since both Owner A and Owner B apparently intend for the young men to acquire the corporation, gifts now seem wise. But, the decision should not be governed by the tax factor alone. All other personal factors must be considered. The gifts have to be real and absolute or they will be set aside. So, once made, the transfers are final.[1/]

SUMMARY AND CONCLUSIONS

The study of Firm H allowed a comparison of tax under alternative forms of organization for a firm which is larger than most of the case study firms. The firm sustained large losses during 1952 through 1954. These losses were so large that they were not used up as net operating loss carrybacks and carryovers before the nine years to which they can be spread had passed. As a consequence, the

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[1/] Unless, of course, a bona fide sale or gift back to the original donor were made. In such an eventuality the burden of proof would be on the taxpayer to prove the reality of the transactions.

partnership form of organization would have given sizable tax savings as compared to the corporate form in which they were organized.

The tax-option election under Subchapter S was not available until 1958. Had it been available during the ten-year period covered by this study, the tax savings of the partnership form could have been availed of. Over $8,700 of tax could have been saved. This saving would have gone far in offsetting some of the disadvantages of the tax-option election which have been pointed out in other chapters.

The study of net operating loss carrybacks and carryovers which was started in Chapter VII was continued in the special analysis section of this chapter by tracing the years to which the large losses of 1952-1954 were carried. The fact that nearly $50,000 of losses never were deductible by the corporation points up the fact that these carrybacks and carryovers, while helpful, still do not fully equalize the tax burden as between the taxpayer with stable income and the taxpayer with fluctuating income.

The two principal owners of Firm H would like to retire from active management of the firm and draw social security retirement payments. Under the corporate form they have used heretofore, this would have been difficult. The tax-option election now makes it possible. Subchapter S therefore allows the stockholders of a close corporation to come within the intent and purpose of the social security insurance program. For stockholders of close corporations who are between 65 and 72 years of age, the tax-option election under Subchapter S will often be wise if they plan to retire from operational responsibility and work in the firm. They can still receive directors' fees and dividends without reducing their social security retirement benefits. The double taxation which is present in the conventional corporate form is eliminated.

If the tax-option is elected, all income should be distributed each year. This cannot be emphasized too strongly.

In order to help visualize the tax effect of making gifts of stock to the sons of Owner A, two sets of projections of the tax which would be paid under the tax-option election were made. These projections showed that some income tax could be saved, but this saving is not significant unless the firm makes large profits. On the other hand, the potential estate tax saving may be highly significant. However, tax is only one of the considerations. Gifts of stock should be continued if these gifts blend with the over-all intent of the owners, but should not be made just for the sake of saving tax alone. Such things as insuring adequate income in old age and for the widows is more important than tax saving.

CHAPTER XI

SUMMARY AND CONCLUSIONS

The preceding chapters of this report have analyzed a few of the most difficult problems which are apt to be encountered by the proprietor who transfers an interest in his business to another person, so has to choose another form of legal organization. That choice is usually the choice between partnership, conventional corporation, and tax-option corporation. The problems encountered in the eight cases are similar to the problems which will be encountered by any businessman who is changing the form of organization of his business.

COMPARISON OF TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

Each case study chapter contains a comparison of the tax which would have been paid by the firm under four alternative forms of organization: (1) partnership, (2) tax-option corporation, (3) conventional corporation with optimum tax planning, and (4) conventional corporation with no tax planning. The total tax which would have been paid by each firm under these alternatives is summarized in Table 41. Eight case studies are not enough to allow the drawing of any general conclusions, but some understanding of the likely results under each form of organization can be observed from a study of this table.

An indication of the size of the firms studied can be gathered from the total sales during the period covered by the study. The eight firms range from Firm D, with average sales of less than $50,000 a year, to Firm H which had over $2 million of sales in 1960. In spite of this range in size of firm, the lowest tax would have been paid in the partnership form in every case. This is to be expected since there is double taxation in the corporate form.

TABLE 41
ALL FIRMS
COMPARISON OF TAX UNDER ALTERNATIVE FORMS OF ORGANIZATION

	Actual Transactions				Tax in Alternative Forms			
							Conventional Corp.	
Firm	Number of Years Included	Total Sales	Total Net Income	Tax Paid	Partnership	Tax Option Corp.	Optimum Planning	No Planning
A	8	$ 669,600	$104,000	$ 17,700	$ 17,500	$ 17,300[a]	$ 17,700	$ 29,900
B	7	358,600	50,400	7,700	7,700	7,700	8,000	11,500
C	7	1,329,300	149,400	22,300	22,300	22,300	22,400	43,800
D	4	299,200	61,500	6,100	6,100	6,100	6,600	6,600
E	2	358,700	(28,300)	100[b]	100[b]	100[b]	1,600[b]	1,600[b]
F	6	613,000	139,100	22,100	22,000	22,700	22,000	39,200
G	3	496,900	81,700	13,800	13,800	13,800	13,900	18,100
H	10	16,969,000	465,200	101,300	92,500	92,500	97,600	101,200[c]
Totals				$191,100	$182,000	$182,500	$189,800	$251,900

[a] The lower tax in the tax-option form, as compared to the partnership form, for Firm A is caused by assumptions relating to fiscal year computations, and not by a basic difference in tax.

[b] Tax paid by Firm E is the total tax paid by the owners in the years to which net operating losses can be carried back.

[c] The computations in the last column for Firm H reflect a division of stock among the sons of one of the owners rather than a "No Planning" situation.

This same lowest tax could have been obtained by seven of the eight firms in the corporate form by electing the partnership-like tax option permitted by Subchapter S of the Internal Revenue Code. On the basis of this information, it appears that many firms could obtain the lowest tax by incorporating and electing the tax-option treatment. Certainly this is what Congress intended when it enacted the law, but, as has been pointed out from time to time in this report, Subchapter S is not a cure-all. There are serious disadvantages which often more than offset the tax advantage which is apparent in Table 41.

One of the disadvantages comes to light when one inquires why the eighth firm, Firm F, did not have the same low partnership tax as the other firms when the tax-option was chosen. The reason lies in the fact that one of the owners had a small capital account. He was not able to deduct his full share of the firm's net

operating loss in the tax-option form, but was able to deduct the full loss in the partnership form. This is an example of the type of hidden dangers which lurk underneath the smooth surface of the election.

One of the most interesting aspects of Table 41 lies in the "conventional corporation with optimum tax planning" column. In nearly every instance, an optimum tax planning formula was found which resulted in a tax which was nearly, but not quite, as low as the partnership tax. The only exception is Firm H, and the reason for the exception there lies in the fact that the firm sustained large losses in 1952-54 which were not recouped before the five-year carry-over of net operating losses ran out.

The optimum tax planning formulas which were used were all directed toward taking the withdrawals from the firm in the form of expenses which are deductible by the corporation rather than as a dividend which is not deductibe. The methods used included paying the officers a bonus based on profits, having the owners make part of their capital contribution in the form of loans to the corporation so that interest on the loans is deductible, renting buildings or other assets to the corporation rather than having the corporation own them, and similar procedures. However, all of these devices are subject to close scrutiny by the Internal Revenue Service and will be disallowed unless they are bona fide transactions backed by sound business purpose and are reasonable.

The comparison of tax which is reflected in the "conventional corporation with no planning" with the tax in the "optimum tax planning" column is startling. It must be emphasized again that this "no planning" column is intended to reflect the way most businesses would handle their affairs if careful thought were not given to tax planning each year. The tax is considerably higher than in any other form for every firm, and is nearly double any other tax for Firm C. Clearly, then, every small business which uses the conventional corporate form must constantly

engage in careful tax planning. Failure to do so makes the corporate form prohibitive. Yet, as was noted in the preceding paragraph, the tax can be nearly as low as in the partnership or tax-option forms if optimum tax planning is carried out.

It would seem, therefore, that the firm which intends to operate without giving thought to tax during the year should probably choose the partnership form of organization. On the other hand, the firm which is willing to do careful tax planning can often gainthe business advantages of the corporate form at little tax cost. This small tax cost is often a small price to pay for the corporate advantage.

SPECIAL FACTORS ILLUSTRATED BY THE CASE STUDY FIRMS

Some of the basic principles which the proprietor who is transferring a portion of his business to another person should keep in mind as he chooses his new form of organization were summarized in Chapter II. Each of the case studies which followed that chapter contained a detailed analysis of one or more complicated features or problems which were encountered by the firm being studied, but which have wide applicability to other firms. The purpose of those analyses was to illustrate and show exactly how these features affected a specific business.

Factors Present When the Choice Is Made

Conflicting Goals

The amount and type of outside income of the owners have a major influence on the exact form the new organization should take. This was mentioned in Chapter II, but was demonstrated specifically in the study of Firm G. Because the former proprietor of Firm G has considerable income from other sources while the employee he was bringing into the business had no outside income, the methods which were most advantageous for one were quite undesirable from the other's point of view. However, when the members of a firm sit down in advance and project the effect of

various alternatives, they can recognize these differences and compensate for them by salary allowances, variation in the division of profits or by other appropriate methods.

Taxable vs. Non-taxable Exchange

One of the important factors which must be taken into account at the time the choice is made is that a transfer to either a partnership or to a corporation can be taxable or non-taxable, but the treatment is entirely dependent upon how the transaction is handled. The choice should be made before the new organization is formed, and certainly before the old business is transferred to the new organization. Every detail should then be handled so as to point toward the choice which is desired. The real intent of the parties and the substance of the transaction are the governing factors.

Capital

The amount of capital which the incoming member can contribute may negate some forms of organization, especially if losses are a possibility. The amount of loss which can be deducted by a partner is limited by the basis of his capital account plus his share of all partnership liabilities. Since liabilities tend to be high when there are losses, this is not often a factor, but is a serious item when it does come into play. In the tax-option corporate form, however, a similar limit on losses is often a real negating factor. The portion of loss which a stockholder of a tax-option corporation can deduct is limited by the basis of his capital account plus the basis of any loans owed him by the corporation. Other liabilities have no effect. So, in those instances where the person being brought into the firm makes little or no capital contribution, the tax-option election should be avoided. Losses which are denied by the basis limitation are forever lost. By contrast, losses which are similarly lost in a partnership can be deducted in the

future when the basis is brought back to a positive balance. These features were discussed in the study of Firms E, F, and G.

Control Limitations

The degree of control which any one owner has in the new organization influences many choices. Generally, losses are denied when the former owner controls more than 50 per cent of the new firm, and capital gains are denied when he controls more than 80 per cent of the new firm. When these factors are present, such things as a stepped-up basis must be foregone.

Debt to Owners

When the corporate form is used, it is advantageous to have the owners make a substantial portion of their contribution to the corporation in the form of loans rather than as a purchase of stock. However, these must be real loans and not equity capital under the guise of debt, or the Internal Revenue Service will treat it as equity capital anyway. The repercussions of such disallowance of debt are serious. So, the conditions present at the time the choice is made must be such that real debt is created, or loans or advances from stockholders should not be made a part of the capital structure. Specific factors which have been used as guides in evaluating the validity of debt from owners were analyzed in connection with the study of Firm D.

Relatives Brought into Business

If the person being brought into the firm is a relative, the choice of form of organization is often more difficult than when the new owner is an outsider. This was emphasized in the study of Firm B. The tax-option election under Subchapter S seems to provide the only workable way for the present owner to sell an interest to his son. The requirements for this election were, therefore, analyzed

in Chapter IV as Firm B was studied. The requirements tabulated therein are simple but the firm must constantly meet every one of them. Failure to fulfill any one requirement at any time brings about automatic termination of the election.

Factors in the Operation of the Business

Losses

The possibility of losses is often overlooked, or discounted, when a new organization is being planned. Yet, the best choice when there are profits is sometimes the poorest choice when there are losses. Considerable emphasis was, therefore, given in the case studies to the effect of losses.

The limiting of the deductibility of losses to the basis of the capital and loan accounts in both the partnership and the tax-option corporate forms was mentioned in the preceding section. Along with these limitations one must remember that corporate losses are not deductible by the stockholders. This means that unless profits are earned by the corporation within five years, losses in a new corporation may also be lost. It is, therefore, possible to lose the tax benefit of operating losses in any form of organization. The situations in which they may be lost are different in each form, however. So, the businessman must give careful thought to conditions under which he might have losses and then choose the form which would give him the maximum tax benefit from those losses should they develop. It is impossible to generalize. He must make his decision by computing his tax under assumed conditions. This usually involves obtaining the assistance of his accountant or attorney to be sure he does not overlook vital factors.

Subchapter S Tax Option

There are hidden traps in the operation of the Subchapter S tax option. Many of these traps can be avoided if the firm which has chosen the election will take a few precautions in the operation of the business. Primarily, this means carrying

out all of the tax planning which is recommended in the "optimum tax planning" program for the conventional corporation. The reason for this is that the tax-option election can be terminated without warning. For example, every stockholder must submit written consent to the election to the District Director of Internal Revenue Service within thirty days after he acquires stock. Failure to do so automatically terminates the election for the whole corporation.

If optimum tax planning has been carried out, no serious harm usually results from termination. On the other hand, suppose that the tax-option corporation had retained considerable amounts of earnings on which the stockholders had paid tax (undistributed taxable earnings). Ordinarily, the distribution of those previously taxed earnings is a non-taxable dividend similar to a withdrawal from a partnership. However, if the election is terminated, future distributions become fully taxable dividends even though the stockholders have already paid tax on the income being distributed. The obvious answer, therefore, is to distribute all of the earnings every year, even though the stockholders have to reinvest them by the purchase of additional stock or by loaning them back to the corporation. It is not necessary that the distribution be in the form of salary or other deductible item, but it is essential that the earnings be distributed. Dividends accomplish the desired result so long as they are chargeable against current or previously taxed earnings.

Elaborate records of earnings must be kept by the tax-option corporation and by each stockholder. The Code and regulations require a three tier tabulation of retained earnings. This is necessary so that dividends can be identified as being chargeable against current or previously taxed earnings which are non-taxable when received by the stockholder while the election is effective, or are from earnings made prior to the election, in which case they are fully taxable. Every attorney and accountant who is advising firms to choose the tax-option election should emphasize the importance of these records. Failure to comply with the regulations could be costly.

Partnership Liabilities

The limitation on deductibility of operating losses in the partnership form carried with it some implications in the operation of the business. Should a firm have a large loss and the owners not be able to make use of the loss because of lack of taxable income in the three preceding years to which net operating loss deductions can be carried or for other reasons, the loss can sometimes be made non-deductible in the year of the loss by having the partnership get rid of as many liabilities as possible. Losses in excess of the partner's basis in his capital account and his share of the liabilities can thereby be deferred until such time as his basis is brought back to a positive balance. The number of years over which the loss can be spread can sometimes be extended by this device. The partners must anticipate the situation, however, and reduce the liabilities before the end of the year as part of the operations of the business.

Social Security

The form of organization under which a business is operated has significant importance in such matters as Social Security retirement pay. The corporate form is often called for when the owners of a business are between the ages of 65 and 72 and want to retire from active participation in the operations of the firm. If the partnership form is chosen, their share of partnership earnings may disqualify them for Social Security retirement pay, but dividends from a corporation do not. This situation was investigated in connection with the study of Firm H, and the conclusion was reached that the tax-option election is particularly adopted to a firm where one or more owners wants to retire from operational responsibility and draw Social Security retirement pay but still keep control of the general policy of the firm. As a director, he can help formulate policy, but his director's fees and his share of the undistributed taxable income of the corporation apparently do not disqualify him for Social Security.

Factors in Termination and Liquidation

Relation of Losses

Firm E is the only case study firm which was liquidated during the period covered by this study. This firm's experience proved that the old adage "operate as a partnership until profits are assured" was only partly true. The earnings of the owners were low in the years preceding formation of the firm so net operating loss carrybacks from the partnership resulted in little or no refunds. On the other hand, the corporate form would have given large capital losses which would have materially reduced tax in future years if the owners had sizable capital gains. Since one of the owners is a farmer who customarily has capital gains treatment on the sale of draft and breeding stock, the corporate form would have been advantageous to him.

Special Provisions for Small Business Corporations

Firm E was organized before the 1958 amendments to the tax law were effective. Had they been organized a year later, use of the corporate form with stock which qualified for the special ordinary loss provisions up to $50,000 a year on a joint return, and election of the Subchapter S tax option, would have had pronounced superiority over the partnership form actually used. It should be noted that these two provisions, although both recommended for Firm E, are entirely separate, different, and unrelated. They were part of different bills, but both were passed in 1958.

Gifts of Stock to Children

The advantages of the corporate form, either conventional or tax-option, in estate planning are many. Although this topic is generally beyond the scope of this report, a brief demonstration of the effectiveness of making periodic gifts of corporate stock to children was made in connection with the study of Firm H.

BROAD GENERAL CONCLUSIONS

Eight firms can be said to have encountered only a few of the factors which are important in choosing the form of legal organization in even the limited situation to which this report has been confined. However, enough factors were encountered and analyzed to indicate the nature of the problem the businessman faced and to point toward some general principles he must follow if he is to pay only his fair share of tax--neither more nor less.

Importance of Computing Tax Under Alternatives in Advance of Making a Decision

Congress faces an almost impossible task in writing a tax law which covers all situations fairly. As time has gone on, they have enacted more and more special provisions designed to accomplish certain things under certain circumstances. However, these special provisions often cause undue hardship to other businessmen who come under their provisions even though Congress did not have them in mind at all when the law was enacted.

As a result, it is impossible for the businessman to be safely guided by generalizations. It is impossible to state, for example, that firms with net incomes of between X dollars and Y dollars should choose the partnership form and that those with larger incomes should choose the corporate form. Similarly, it is impossible to say that the transfer of the old business to the new organization should be handled so as to be a non-taxable exchange under certain conditions, but should be handled so as to be a taxable sale under other specific conditions. There are too many special conditions in each business which affect the proper choice. The businessman often looks for general rules which will make his decision easy, but the fact remains that this search is nothing more than wishful thinking.

The only safe procedure for the businessman to follow is to compute exactly what his tax will be under each form of organization under all of the earnings and

other conditions he is at all likely to encounter. This means hard work and the assistance of his accountant and attorney unless he is especially versed in tax matters himself. Yet, with today's complicated tax structure, there is no other reliable way for him to obtain satisfactory answers.

Much of this report has been devoted to demonstrations of the type of computations and projections which need to be made before a choice of form of organization is made. These computations were of two broad types. One type was used in Chapter VIII to obtain an understanding of exactly what the law means. When the basis limitations on net operating losses of a tax-option corporation were compared with partnership capital accounts, the real significance of the provisions was revealed. This understanding cannot be obtained by just reading the law. The second and more important procedure to the average businessman was the projection of future taxes under alternatives the business might consider. Chapters IX and X concentrated on this use of the computations.

Some Observations About Subchapter S

Since the partnership-like tax-option authorized by Subchapter S is comparatively new in the tax law, a few observations about that form of organization is an appropriate way to conclude this report. The purpose of the provision was to allow businessmen to choose their form of organization according to the business and operational advantages of each form without having tax considerations dictate the choice. This goal has not been reached. Businessmen now have three basic choices instead of the two they formerly had. In addition to the old partnership and corporation choices, they must also consider the tax-option corporation. The choice has been made more difficult rather than easier.

However, the use of the tax-option corporation has solved many problems. Practically every one of the case studies revealed situations where the use of the

corporate form with tax-option election gave a more equitable tax than either the partnership or the corporation. Generally speaking, this election allows the firm to obtain the business and organizational advantages of the corporation but retain the lower tax which goes with the partnership form. So, basically, the tax-option corporate form is a wise choice for many firms.

The tax-option corporate form must not be used indiscriminately, however. There are many pitfalls and hidden traps in its use which can cause disastrous tax results. No one should adopt this form without first being thoroughly schooled in the nature of these pitfalls and the uncertainties which exist in the law, and in how to protect himself against them. Several of the pitfalls were pointed out in the case study chapters, but many more exist. They show up at the most unexpected places and cause all kinds of trouble. The case studies were directed toward showing how to uncover them, not toward finding all of them.

One of the fundamental protections against the pitfalls lies in realizing that the election may be terminated by so many eventualities that the businessman must operate his tax-option corporation as though the election were going to be terminated the next day. This means that he must engage in even more careful tax planning than he does under "optimum tax planning" in the conventional corporate form. He must be particularly careful to distribute all income every year. He must strive to have the basis of his capital and loan accounts be higher than any possible operating losses even though this means borrowing money personally and loaning it to the corporation. He must constantly question each transaction to see if there are any hidden "booby-traps" in Subchapter S which the transaction might trip.

In summary, the intent and purpose of Subchapter S and its tax-option election is commendable. It has solved many tax inequities. It fits the operational plan of the small business well. But, the specific way in which the law is written and administered have had detrimental effects in situations which Congress did not, and

could not, anticipate when the law was written. Until some of these are ironed out by future legislation, the only firms which should choose the tax-option election are those which keep in constant touch with both an accountant and an attorney who have made a careful study of this section, or who are willing to run the risk of being caught in one of its booby-traps.

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NOTICE

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